The Accounting Review

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EXECUTIVE COMMITTEE

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ACCOUNTING CONCEPTS AND STANDARDS UNDERLYING CORPORATE FINANCIAL STATEMENTS

1948 REVISION

PREFATORY NOTE

IN JUNE, 1936, the executive committee of the American Accounting Association issued a tentative statement of accounting principles relating to the financial reports of business corporations. This was followed five years later by a revision entitled "Accounting Principles Underlying Corporate Financial Statements." In this third statement the committee reaffirms and restates the following preliminary considerations expressed in the 1941 statement:

(a) The basic objective has been to stimulate the continued study and discussion of accounting standards and their periodic restatement, thereby assisting in the orderly development of accounting concepts and their wider acceptance both among accountants and among others in any way influenced by or interested in the findings of accountants.[1]

(b) So many decisions are dependent on interpretations of corporate reports that uniform, objective, and well-defined standards have become a requisite for the use of the reports by persons having an interest in an individual enterprise or in the broader problems relating to the national economy.

(c) Because basic accounting concepts and standards remain relatively undisturbed even during periods of economic change, restatements will involve primarily changes in emphasis.

(d) Although a comprehensive understanding of the financial position and operating activities of a corporation is derived only in part from financial statements, it should nevertheless be possible for a person moderately experienced in business and finance to obtain from such statements basic information on which he may rely with confidence.

(e) In the application of standards individual differences in industries or in enterprises within an industry may require that allowance be made for well-established practices, but the standards here recommended are believed to be capable of general application. Any deviation therefrom should be carefully weighed and, if made, disclosed both qualitatively and quantitatively in the financial statements.

The acceptance by any business organization of the concepts and standards presented here should be viewed not as a sub-

[1] Although seldom given express recognition, accounting concepts are embodied in a framework of underlying conditions and assumptions, such as (a) a business entity with an income objective, (b) a continuity of operations as a going concern, (c) the accrual basis of accounting, (d) the need for periodic reporting, and (e) the preparation, from underlying data, of statements embodying the point of view of stockholders.

mission to arbitrary rules and restraints but as providing an opportunity for interpretation and comparison by means of the common language of accounting.

ASSETS

The assets or economic resources of an enterprise are its rights in property, both tangible and intangible. The most commonly useful financial statements report the origin and disposition of the assets of an enterprise in terms of costs established and recorded at the time the assets are acquired. The importance of costs as a record of the accountability of an enterprise for its resources makes it essential that their determination be based on available objective evidence. When an asset is *purchased* such evidence is found in the cash outlay, in the fair market value of any noncash consideration, or, in the absence of these measures of cost, in the fair market value of the asset acquired. The measure of cost for an asset received through a *revenue* transaction is fair market value, ordinarily indicated by the established selling price of the goods or services sold. Where an asset is acquired from investors or donors its cost for accounting purposes is fair market value at the time of acquisition.

(1) The cost of a group of assets acquired for a lump sum should be allocated to property units, tangible or intangible, after careful consideration of the nature and condition of each unit, and its intended use and prospective earning power or value in exchange.

(2) If an asset has use or exchange value for a limited period, whether resulting from operations or other events, its cost must be reasonably and systematically assigned to expense or transferred to other assets. The portion of recorded cost to be reported in the balance sheet is the amount assignable to future periods. Where an asset or asset group will be continued in use this amount is the portion of cost recoverable through the remaining useful services the asset is expected to yield. For a fixed asset held for sale the balance-sheet amount is that portion of cost not in excess of the expected net proceeds. A decline in the cost of replacement or reproduction is not conclusive evidence that a portion of unassigned cost cannot be recovered.

(3) There should be no departure from the cost basis to reflect the assets of an enterprise at amounts higher than unassigned costs. Continuous replacements of assets, frequently of a type different from those replaced, and the practical difficulty of measuring replacement values, emphasize the need for a historical record in terms of the consistent, objective basis of cost.[2]

(4) Adherence to the cost basis of accounting requires that there should be no suppression or unwarranted assignment to expense of the costs of existing assets.

INCOME

The income of an enterprise is the increase in its net assets (assets less liabilities) measured by the excess of revenue over expense. The income of a corporation is not affected by the issuance, acquisition, or retirement of the corporation's own capital shares, adjustments of stockholders' interests, or dividend distributions by the corporation.[3]

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[2] Readers of financial statements may be aided in their interpretations by considering the effect of fluctuations in the purchasing power of money. A marked, permanent change in price levels might impair the usefulness of statements reporting asset costs; however, price changes during recent years do not afford sufficient justification for a departure from cost. Accounting concepts and standards appropriate for the reflection of a drastic and permanent change in prices would need to be developed in the event of such a change.

[3] It is recognized, however, that claims or obligations which have arisen from revenue or expense transactions are occasionally settled by the acquisition or issuance of the corporation's own capital stock; e.g., shares may be issued in connection with employment contracts.

Revenue

Revenue is a generic term for (a) the amount of assets received or liabilities liquidated in the sale of the products or services of an enterprise, (b) the gain from sales or exchanges of assets other than stock in trade, and (c) the gain from advantageous settlements of liabilities. Revenue does not arise from a gift.

Revenue is recognized upon the transfer of an asset, the performance of a service, or the use of a resource of the enterprise by another party, accompanied by a concurrent acquisition of an asset or a reduction of a liability.

(1) When the consideration received from a customer is an asset other than cash, the fair market value of the asset is ordinarily indicated by the established selling price of the goods or services sold.

(2) Revenue from interest, rent, royalties and similar contracts should be recognized on an accrual basis in accordance with the conditions of the contract.

(3) The usual criteria for the recognition of revenue are subject to modification where there is an extended period of collection or where related expense of substantial amount is to be incurred after the date of sale.

(4) The appreciation or enhancement of asset values resulting from increased market prices is not recognized as revenue prior to sale.

Expense

Expense is the cost of assets or portions thereof deducted from revenue in the measurement of income. These deductions arise through a current expenditure of cash, a total or partial expiration of asset cost, or the incurrence of a liability. Expense consists of operating costs—deductions that have a traceable association with the production of revenue, and losses—deductions that have no such association.

(1) Expense is given recognition in the period in which there is (a) a direct identification or association with the revenue of the period, as in the case of merchandise delivered to customers; (b) an indirect association with the revenue of the period, as in the case of office salaries or rent; or (c) a measurable expiration of asset costs even though not associated with the production of revenue for the current period, as in the case of losses from flood or fire. The revenue deductions of a period include all costs not previously deducted from revenue and not applicable to future periods.

(2) Expense not subject to precise measurement should be based on estimates of a definitive and consistent character and should be in reasonable conformity with policies generally established within the industry or trade.

(3) The cost of an intangible asset which has a limited-term significance should be assigned to expense by systematic timely charges.

(4) For purposes of determining the expense of a period, it is acceptable to assume a flow of the cost of inventoriable items, for example, "first in, first out." The residual cost should be carried forward in the balance sheet for assignment in future periods except when it is evident that the cost of an item of inventory cannot be recovered, whether from damage, deterioration, obsolescence, style change, oversupply, reduction in price levels, or other cause. In such event the inventory item should be stated at the estimated amount of sales proceeds less direct expense of completion and disposal. This concept of residual cost may be applied to inventory items, a group of inventory items, or to total inventory. The method of inventory costing should be consistent from period to

period and should conform reasonably with practices established within the industry or trade.

(5) An assignment of all or a portion of the cost of an asset to expense, made in good faith after considered judgment and after competent review, in accordance with the accepted accounting concepts and standards of the time, is not subject to reversal in a later period. Errors of a mechanical and nonjudgment nature should be corrected in the period of their discovery.

(6) The creation of or addition to a reserve by a charge against revenue, except in recognition of expense, defers the recognition of income and impairs the significance of the financial statements.

LIABILITIES AND STOCKHOLDERS' INTEREST

In a corporation, there are two classes of equities: liabilities and stockholders' interest. They are given accounting recognition at the time assets or services are received or obligations are incurred by the corporation.

Liabilities

Liabilities are claims of creditors against the enterprise, arising out of past activities, that are to be satisfied by the disbursement or utilization of corporate resources. They are measured by cash received, by the established price of noncash assets or services received, or by estimates of a definitive character when the amount owing cannot be measured more precisely.

(1) Any difference between the amount payable when a liability is settled and the amount of the cash or its equivalent received when the liability is incurred should be accumulated or amortized systematically during the period the obligation is outstanding.

(2) When a liability is liquidated, any difference between the amount of assets disbursed and the amount of the obligation as then reflected in the accounts is revenue or expense of the period of liquidation.[4]

Stockholders' Interest

Stockholders' interest is the investment of the owners in the enterprise, consisting of paid-in capital and retained income.

(1) Paid-in capital is measured by the cash, or the fair market value of other assets or services, contributed by stockholders or by persons acting in a capacity other than that of stockholders or creditors, or by the amount of liabilities discharged upon the transfer of an equity from a creditor to a stockholder status. Paid-in capital may be reduced by the redemption or other reduction of outstanding shares, payments of liquidating dividends, or adjustments effected by a corporate reorganization. The reduction of paid-in capital upon the contraction of outstanding shares may not exceed the prorata portion of paid-in capital applicable to the number of shares contracted.

(2) Retained income is the amount of income since the formation or a reorganization of the enterprise less the amount distributed to stockholders. Distributions include dividends and the excess of the amount of assets disbursed in the reacquisition of shares of capital stock over the prorata portion of paid-in capital applicable to such shares. The distinction between paid-in capital and retained income should be permanent. Where retained income has been designated as paid-in capital by means of stock dividends, recapitalizations, or by other customary corporate action the amount so

[4] The conditions which permit the discharge of a liability at substantially less than the amount reflected in the accounts may be indicative of previously unrecognized or contingent losses.

designated should be indicated in the balance sheet.

FINANCIAL STATEMENTS

Financial statements require not only the application of generally recognized accounting concepts but also adequate presentation and disclosure. Standards for statement presentation include the following:

(1) Assets should be classified in such a manner as will facilitate the accounting for their utilization and the preparation and interpretation of financial statements.

(2) When a separate account (e.g., a depreciation reserve) is used to show the portion of an asset cost assigned to expense, the account should be deducted from the related asset account in the balance sheet.

(3) Assets and liabilities should not be offset unless required by law or contract.

(4) The method of inventory costing should be revealed in the balance sheet.

(5) In exhibiting a long-term liability disclosure should be made of the maturity amount and other significant characteristics of the obligation.

(6) Conditions limiting the disposition of retained income are preferably disclosed by parenthetical comment or footnote. A reserve required by law or contract should be created from retained income and returned undiminished to retained income when the need for it has passed. The determination of income or of the amount of net income carried to retained income should not be affected by the creation or disposition of such reserves.

(7) An outlay by a corporation for shares of its own stock should be treated as a reduction of paid-in capital up to the prorata amount represented by the acquired shares, whether or not such shares are reissuable. If the outlay for the reacquired shares exceeds the prorata reduction of paid-in capital, the excess should be treated as a distribution of retained income. The reissue of acquired shares should be accounted for in the same manner as an original issue of corporate shares.

(8) When values of assets other than costs applicable to future periods are supported by substantial objective evidence, and are materially higher than the cost applicable to future periods, such data may be essential in interpreting the economic position of the enterprise. Such information, adequately described as to nature and source, may be shown parenthetically, by footnote, or in a supplementary schedule.

(9) The income of an accounting period should be reported in a statement providing an exhibit of all revenue and expense (including losses) given accounting recognition during that period. This practice assures that the income statements for a period of years will disclose completely the entire income history of that period.

(10) The income statement should be arranged to report consistently and in reasonable detail the particulars of revenue and the expense pertaining to the operations of the current period, measured as accurately as is possible at the time the statement is prepared and also any items of revenue or expense not associated with the operations of the current period. Such arrangement of data in a single statement discloses both the earning performance and the entire income history of the enterprise during a given period.

(11) The income statement should reveal the amount of cost assigned to expense by reason of any reduction of an inventory to its recoverable cost.

(12) The effect on income taxes of an unusual item of revenue or expense should be disclosed whenever the effect is material. Similarly, disclosure should also be made of material tax consequences resulting from differences in financial and tax ac-

counting. Such disclosures should not be made by the adjustment of the "provision for taxes" reported in the income statement; this caption should be used for the actual taxes paid or estimated to be payable.

(13) A change in paid-in capital and retained income such as one resulting from the issuance, acquisition, conversion or exchange of capital stock, and from stock dividends, should be disclosed in the financial statements of the period in which the change occurs. Distributions to stockholders and preferences attaching to the ownership of particular classes of shares or capital stock should also be disclosed.

(14) The balance sheet should contain no special section for reserves. Each reserve should be identified as (a) a subdivision of retained income, (b) an asset or a liability valuation account, or (c) a liability, and the position of the reserve in the balance sheet established accordingly.

CONCLUDING COMMENT

If accounting standards are to merit acceptance, financial statements in which they are incorporated must supply dependable information for the formulation of judgments. These judgments, made in an economic setting subject to important changes, can be relied upon only if such standards are adhered to consistently. Changes in accounting policy should be limited to those that will lead to improved standards.

Accounting for the business activities of modern corporations will continue to offer many problems. As business structure becomes increasingly complex, the special and often diverse interests of investors, management, labor, and government will place increasing demands upon accounting and accountants. The application of accounting concepts and standards in the solution of those problems requires on the part of accountants a high degree of integrity, competence, and social responsibility.

* * *

This statement is issued by the Executive Committee of the American Accounting Association in June, 1948. The preliminary draft of the statement was prepared by a special committee appointed in 1946. The members of this special committee were:

Herbert E. Miller, Chairman
Hermann C. Miller (ex officio)
Paul J. Graber
Thomas W. Leland
James R. McCoy
Hale L. Newcomer

Acknowledgment is made of the valuable suggestions received from many members of the American Accounting Association who reviewed the preliminary draft.

Executive Committee, 1948

Thomas W. Leland, President
Victor Z. Brink, Vice President
S. Paul Garner, Vice President
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Clete F. Chizek, Secretary
Robert L. Dixon, Editor, Accounting Review
Paul J. Graber, Director of Research
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Harvey G. Meyer, Past President
Hermann C. Miller, Past President

PRESENTATION OF PERTINENT DATA IN FINANCIAL STATEMENTS

Earle C. King

The accountants of Ohio have been quite generous in their invitations to representatives of the Securities and Exchange Commission to appear before them on various occasions. Of particular interest to me is the appearance of the late Commissioner George C. Mathews' name in the list of speakers at your first annual institute on accounting. It is indeed a pleasure to have the opportunity to appear here today and discuss some of our common problems in the presentation of pertinent data in financial statements.

A review of the proceedings of these Institutes on Accounting discloses that the field of accounting has been explored most thoroughly in special fields, as well as its broader aspects, and that from time to time the subject of generally accepted accounting principles and their application to what may be considered the end result of the accounting process—the financial statements—has been discussed.

The first session of your meeting in 1941 was devoted to the subject of "Accepted Accounting Principles." In introducing a progress report on the American Accounting Association's statement of accounting principles the first speaker deplored the existing state of affairs as reflected in financial statements. Conflicting treatments of fixed assets, depreciation, reserves, inventories, capital stock, surplus, and profit and loss were cited. Dismissing the idea that it is impossible to reduce accounting to stated rules or standards, the speaker allied himself with that group of accountants who "have consistently held that there is great need for a statement of principles, and that this statement should come from the profession rather than from the SEC or other governmental agency."

From the outset the Commission has been sympathetic to this point of view and has sought the advice of leading accounting authorities in teaching, public practice, and among executives of corporations, investment bankers, and financial analysts in the preparation of rules, regulations, and forms necessary in the administration of the Acts which authorize the Commission to prescribe the forms, items, and details of financial statements to be filed generally, uniform systems of accounts (as for public utility holding companies), and "a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounting records and in preparing financial statements." Except to the extent indicated for the special fields mentioned, we have not attempted a comprehensive statement of accepted accounting principles. On individual problems, however, where our experience has disclosed serious discrepancies in practice as between companies and accountants and we have felt that uniformity in procedure would benefit investors, our conclusions have been expressed by rule or regulation of the Commission or in an opinion of the Chief Accountant. The principal requirements of this type are published in Regulation S-X relating to the form and content of financial statements and in our Accounting Series Releases.

Our approach to this problem of uniform application of accounting principles I believe is a necessary practical recognition of conditions found in business and the accounting profession. Under the direction of the Commission the administration of our accounting rules is entrusted to

members of the staff who have had experience in business or professional practice of accounting. They are familiar with the problems involved in recognizing exceptions to those generally accepted accounting principles in conformity with which the independent accountant asserts the financial statements have been prepared.

While we recognize that the American Accounting Association's statement of principles has not received unanimous endorsement by practicing accountants, we nevertheless find it to be a helpful document and guide in testing our own thinking on many problems. The American Institute of Accountants has been less bold on this subject than the teachers of accounting and as a body has given recognition to only six unintegrated "rules" which were adopted in 1934.[1] These rules, and the content of the succeeding Accounting Research Bulletins with which you are all familiar, have likewise been extremely helpful guides in our accounting work although we have taken exception to some of these pronouncements, particularly those which fail to take a clear-cut position with respect to the treatment of items in the determination of income.

Returning now to Regulation S-X, for the benefit of those who may not have had to use it, I want to emphasize that the rules contained in it prescribe the method of presenting pertinent data in financial statements to be included in registration statements and reports to be filed with the Commission. Regulation S-X does not prescribe a uniform system of accounts except that under the Investment Company Act of 1940 the prescription of the form of preparing financial statements of investment companies has the effect of "providing for a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounting records. . . . "

It should also be noted that railroads, operating public utilities, banks, and insurance companies subject to state or federal supervision comply with the reporting requirements of Regulation S-X by filing part or all of the statements, or statements complying with uniform systems of accounts, prescribed by such other agency as has jurisdiction. Such statements are subject to the rule, however, that "The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

At this point it may be appropriate to consider the question of footnotes as a means of supplying "pertinent data." A short time ago we had a letter from a student of accounting who was engaged in writing a paper on this subject. This student desired to confirm his impression that the S.E.C. was opposed to footnotes to financial statements. I think we have, on occasion, deplored the incomprehensible language and the length of some of the footnotes accompanying financial statements filed with us. However, Regulation S-X recognizes that there are many pertinent data which should be disclosed with respect to the financial statements which by nature cannot be conveniently incorporated on the face of the statements. I am convinced that the activities and financial problems of most of our large corporations, and to a lesser extent the smaller corporations, are so complex today that much of the significance of the financial statements would be lost without careful consideration of the content of the foot-

[1] See Accounting Research Bulletin No. 1 issued in September 1939.

notes. I cannot imagine returning to financial statements without footnotes and relying on the auditors' "certified correct" or perhaps a treasurer's similar statement subject to the warning "E and O E." In addition to the footnotes we require schedules in support of certain balance sheet and profit and loss items. The schedule of supplementary profit and loss information is the only one for an industrial company required to be included in the prospectus; and this may be accomplished in a footnote by even the largest corporations.

Recent examples of the treatment of footnotes may indicate the importance of the material disclosed. An annual report of a manufacturing corporation filed on Form 10-K included a balance sheet showing total assets of $9,000,000. The single footnote appeared on the face of the statement and related to contingent liabilities in connection with pending suits against the company. The same item appeared in the published report to stockholders. The related profit and loss statement required two notes under our rules, one relating to inventories and the other to the depreciation policy of the company. Neither of the notes appeared in the report to stockholders.

The published report to stockholders of a progressive corporation with total assets of approximately $40,000,000 carried one note on the balance sheet relating to the borrowing of funds for the expansion of plant. The profit and loss statement carried two notes—one relating to Section 722 claims and the other to the inclusion of profits of a new subsidiary. A prospectus for this company using the same financial statements required five additional notes to the balance sheet; two related to principles of consolidation, one to valuation of assets, one to increase in the company's authorized capital stock (covered in the president's letter in the published report), and one we required with respect to the use of a reserve for possible future inventory price declines. Six notes to the profit and loss statement in the prospectus included supplementary profit and loss information, inventory data, depreciation policy, equity in subsidiary profits not consolidated, the Section 722 claims, and awards under a management profit-sharing plan. All of the information disclosed seemed to me to be pertinent and useful to financial analysts. A sampling of 1947 annual reports to stockholders discloses that many of our largest corporations manage to get the notes to financial statements on one printed page set up in a most readable style. Notes common to most reports include principles of consolidation, foreign operations, inventories taxes, and contingent liabilities.

A recent prospectus and annual report of Swift & Company presents within the experience of one company most of the outstanding problems currently under discussion. An important requirement of Regulation S-X is the disclosure of any significant change in accounting principle or practice and an explanation if the change substantially affects a proper comparison with the preceding year. The independent accountants call attention in their certificate to a change in the method of valuing "Lifo" inventories and the notes explain the substantial effect. Although the adjustments made were believed to affect prior years to 1941, the entire correction of approximately $5,000,000 was made as a charge to 1947 income, shown separately in the prospectus income statement but merged in cost of sales in the report to stockholders. The adjustment was shown as a special charge in 1947 in the ten-year summary of earnings because, as a note states, of the impracticability of determining the amounts applying to the six individual prior fiscal years.

"Lifo" inventories are a feature of an extensive note on reserves in the prospec-

tus. The note explains the presence among current liabilities of an item "Reserve for replacement of basic 'Lifo' inventories (net after income taxes)" which arises from the adoption during 1946 of procedures relating to replacement of basic inventory quantities involuntarily reduced because of the war emergency. The resulting adjustments were material and affected income from 1941 through 1947, appropriate corrections being made in the summary of earnings and the three-year income statement, with related adjustment of tax claims—also a material item.

Three other reserves covered by the note in the prospectus, but without comment in the published report, appear immediately above "Capital Stock and Earned Surplus" under the caption "Reserves," qualified in the prospectus only in parentheses "Appropriated from earned surplus":

General Reserve	$16,000,000
For high cost additions to fixed assets	12,000,000
For inventory price declines	5,767,000
	$33,767,000

A still better presentation of these items, in my opinion, would be to show them as a subdivision of earned surplus as I have seen done in the report of one large corporation.

These three reserves are examples of the subject matter of the American Institute of Accountants' Accounting Research Bulletins Nos. 28, 31, and 33 respectively. Footnote explanation indicates that the first item is a general purpose contingency reserve of the type covered by Bulletin No. 28 which permits the showing of appropriations and return of appropriations to such reserves on the income statement after a clear designation of income, although expressing a preference for recording through the surplus account. I agree with the three members of the committee who thought that despite every effort at clear disclosure on the income statement many readers would be confused. Sometimes this confusion is compounded by the test of the report to stockholders which may infer that income should be considered to be the amount remaining after the appropriation to reserves.

Similar considerations apply with even more force, in my opinion, to the inventory reserve. Again the Institute Bulletin No. 31 favors the surplus segregation or appropriation treatment but recognizes as proper, but less desirable, the showing of the appropriation on the income statement. The Swift explanation of their reserve for inventory price decline states that the amount has remained unchanged since 1938, a year of price declines, in which $11,000,000 was restored to surplus from appropriations made in 1933, 1934 and 1935. The purpose of the reserve is stated to be:

> This reserve was not made as against inventory carrying values at the close of the fiscal years but was primarily made as an appropriation of profits earned in a period of rising prices as a carry-forward to offset future losses or reduced profits in a period of declining prices, when and if such a condition should eventuate. It is not the Company's intention to utilize this reserve to absorb inventory losses which are properly allocable to future periods.

That appears to be a clear-cut application of the procedure favored in Bulletin 31 and required by the Commission.

The reserve "For high cost additions to fixed assets" reflected on the balance sheet was provided in 1947 and shown on the income statement in the prospectus as "Appropriation for high cost additions to fixed assets" following a caption clearly designated "Net Income" with the remainder designated "Balance to earned surplus." In this case the company uses a combined income and surplus statement, completing the statement in four lines by adding the opening balance, deducting dividends and arriving at "Earned surplus at end of period." The summary of earnings is in accord with this treatment but

footnotes the "Net Income" by observing that $12,000,000 has been appropriated to reserve for high cost additions to fixed assets.

It is pertinent to observe that the annual report to stockholders, published months before the prospectus, contains a combined "Statement of Consolidated Income and Accumulated Earnings" which is a fair sample of the confusion the Commission recognized could arise in the application of Accounting Research Bulletin No. 32 when the staff was authorized to take exception to financial statements which appear to be misleading, even though they reflect the policy laid down in the bulletin. For example:

Net Income for the Year (see reserve appropriation following).		$34,334,977
Provision for high cost additions to fixed assets		12,000,000
Amount of Net Income Transferred to Accumulated Earnings		$22,334,977
Other additions to and deductions from accumulated earnings:		
Reversal of reserve for deferred maintenance of properties.	$3,000,000	
Adjustment of prior years' Canadian taxes and subsidies.	426,703	
	$3,426,703	
Exchange adjustment in converting net assets of Canadian subsidiaries into U. S. Dollars	1,012,974	2,413,729
		$24,748,706
Accumulated Earnings, October 26, 1946		119,143,149
		$143,891,855
Dividends Paid During Year, $2.10 per share		12,436,612
Accumulated Earnings, November 1, 1947		$131,455,243

(See Notes to Financial Statements)

What the reader is intended to take as Net Income is further confused by turning the page in the report to a fifty-year financial record in which for 1947 the figure of $24,748,706 is shown in the earnings column and reduced to $4.18 per $25 share and 1.1 cents per dollar of sales. A footnote to the amount of earnings reads:

> Includes reversal of reserve for defined maintenance of property of $3,000,000; less Canadian tax and exchange adjustments of $586,271 net, and after provision of $12,000,000 for High Cost Additions to Fixed Assets.

The president's report to the shareholders includes the following paragraph:

> Earnings Reflect Successful Year—Net earnings from all operations were $22,334,977 after provision of $12,000,000 for high cost additions to fixed assets. (See special reference under financial position, Page 6.) Although our net earnings were larger than a year ago, our earnings per dollar of sales amounted to one cent as compared to 1.3 cents in 1946. (For the distribution of Swift's average 1947 sales dollar, see chart on Page 5.)

The pie chart shows "Remaining as Earnings 1.0¢," and the reference on page 6 is: "Under normal conditions the depreciation heretofore provided would have been sufficient to cover the cost of current replacements. However, because of the present abnormal price level it was deemed prudent to set aside a reserve for high cost additions to Fixed Assets of $12,000,000." On page 2 of the report "Financial Highlights" presents a five year comparison which includes Earnings for 1947 as $22,335,000 footnoted "After provision of $12,000,000 for high cost additions to fixed assets" and per share earnings $3.77 and per dollar of sales one cent. Here we have three figures reported as net income or earnings for the year ($34,335,000; $24,748,000; and $22,335,000) with the last figure, the smallest, emphasized in the text of the report.

Perhaps this sort of thing is what the editors of the *Journal of Accountancy* had in mind in February of this year when they wrote under the title

> Appropriations of Income and Earnings Per Share: Recent reports of a number of companies . . . have violated the spirit and intent of this well considered accounting convention [that provisions for vague or highly discretionary

reserves should not be permitted to affect the reporting of net income], even while appearing to observe its letter. When a reserve of the type under discussion is provided as an appropriation of the current year's income, rather than of surplus, the wording describing the provision, and the balances before and after its deduction, become highly significant. When the final balance transferred to surplus is so captioned as to appear to be the net income, or is elsewhere cited as though it were the net income of the year, or is used as a basis of computing earnings per share, the purpose of excluding the provision from the determination of net income tends to be defeated.

and that

The basic principle which requires the exclusion of "appropriations" from the determination of net income is clearly violated when the computation of earnings per share is based on the balance remaining after their deduction. At best this practice is confusing; at its worst it can be seriously misleading.

In discussing the Swift report and prospectus reference has been made to the summary of earnings in the latter and to the fifty-year financial record and five-year financial highlights in the former. These are useful devices for presenting pertinent data concerning the growth of the business but require careful compilation in order to assure reasonable comparability. This subject was covered very briefly in a footnote to our Accounting Series Release No. 62 with respect to the circumstances under which independent public accountants may properly express an opinion as to such summaries. This footnote reads:

Ordinarily, the summary earnings table will reflect the operations of the registrant, or of the registrant and its subsidiaries, during the period covered. However, under special circumstances, as where the registrant has succeeded to the business of one or more predecessors, it may be necessary for the summary to be specially constructed so as to reflect as far as possible for the period covered the earnings applicable to the enterprise now represented by the registrant. Where, for example, a predecessor operated as a partnership it is ordinarily necessary to indicate in an appropriate manner the adjustments required to place the partnership income on a corporate basis. In other unusual cases there may have been such violent and radical changes in the business of the registrant that a long summary of past earnings might be of very little or no value and might well be misleading. In several such cases, the registrant has been requested either to delete the summary entirely or to furnish only a brief statement of the overall, aggregate results, without a breakdown as between the several years. In any case, where special and unusual circumstances exist, a decision as to the content of the summary and as to whether or not a summary should be furnished at all can only be reached after careful appraisal of the particular facts of each case.

An interesting application of the principles set forth in this footnote appeared in Chrysler Corporation's first quarter financial statement published in the (Washington, D. C.) *Evening Star*, May 8, 1948. The "Comparative Consolidated Statement of Net Earnings [for the] Three Months Ended March 31" included the years 1948, 1947, 1946 and 1941 "in which" it is explained "the principal activity of the Corporation and its subsidiaries was the manufacture and sale of automotive products."

Another variation of the idea appeared in the 1947 annual report of Standard Oil Company (New Jersey) in which a Financial and Operating Summary compared 1947, 1946 and the average for 1941–1945. Whether an average for any period is a suitable basis for comparison must depend on the character of the business during the period as in some cases a showing of fluctuating results from year to year may be more representative of the character of an enterprise.

Reverting again to Regulation S-X let us consider Rule 3-01 of which section (a) provides that "Financial statements may be filed in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto."

Article 5 of Regulation S-X governs the form and content of financial statements

for all persons except investment companies, insurance companies, committees issuing certificates of deposit, banks, and companies in a developmental or exploratory stage for which special instructions are provided in the regulation or in the forms required to be filed. The form, order, and terminology adopted in this article for the balance sheet and profit and loss statement may, I believe, be considered a proper reflection of generally accepted practice at the time of its adoption (1940), as the regulation was subjected to extensive and intensive criticism by all interested parties prior to promulgation.

The balance sheet is presented in a current-to-fixed order and the profit and loss, or income, statement presents a showing in order, of sales; cost of sales; (or operating revenues and operating expenses where appropriate); other operating expenses; selling, general, and administrative expenses; other income; income deductions—arriving at net income before and after provision for income and excess profits taxes. An analysis of surplus is required either as a continuation of the related profit and loss statement or in the form of a separate statement of surplus.

It should be observed at this point that sections 7 and 10 of the Securities Act of 1933 require a registration statement and prospectus to include the financial statements prescribed in Schedule A of the Act. This schedule permits the Commission considerable latitude as to form and detail of the financial statements but requires specifically that the profit and loss statement shall "differentiate between any recurring and nonrecurring income and between any investment and operating income." The Securities Exchange Act of 1934 in Section 13 with respect to periodical reports provides that the Commission may prescribe similar requirements. Under the 1933 Act serious consequences may result if the financial statements contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements not misleading. A similar admonition appearing in the 1934 Act provides penalties in case a statement at the time and in the light of the circumstances under which it is made is false or misleading with respect to any material fact.

It will be recognized that the Regulation S-X option of combining the profit and loss and surplus statements in one statement is in accord with the trend at the time as reflected in Accounting Research Bulletin No. 8, issued by the A.I.A. Committee on Accounting Procedure in February 1941. This bulletin, however, warned against the danger of obscuring the net income figure. With the publication of Accounting Research Bulletin No. 32 in December 1947, this warning becomes extremely important since, as I stated in a letter to the Director of Research of the Institute, dated December 11, 1947, which was published in the January, 1948, *Journal of Accountancy*, the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of this bulletin. The discussion of the Swift report seems to me to indicate this apprehension was well founded.

Developments during the war in the method of doing business—in many cases practically complete conversion to war contracts—and a growing inquisitiveness on the part of labor concerning facts about the business, put pressure on corporate officials and their accountants to devise a new form of profit and loss statement and a substitute for the balance sheet form of statement of financial condition. The "single step" form of profit and loss statement was the first to come to our attention and to be given serious consideration.

This new form of profit and loss statement was offered by several prominent and large corporations as full compliance with Regulation S-X, Rule 3-01 relating to form, order, and terminology being cited in justification for the departure from the forms previously filed in the order set forth in Article 5 of the regulation. A group of leading independent accountants appeared informally before the Commission to urge that Regulation S-X be amended so as to permit wide freedom in the form and order of the profit and loss statement. After study of the matter the Commission reached the conclusion with respect to this proposal that its rules as to form and order of statement should not be changed.

Three reasons were given. First, it was felt that a convincing case had not been made in favor of the proposed new form and order. Second, it was believed that the new ideas had not yet gained sufficient recognition in actual practice to warrant adoption by the Commission in the face of its own doubts. And, third, the opinion was held that the proper place for experimentation of this kind was not in reports required to be filed with the Commission, but rather in the annual reports furnished by companies to their stockholders.

The Commission emphasized that it did not wish to be regarded as opposing constructive changes, as such, that it was receptive to proposals of this character, and that if and when the proposed form of profit and loss statement became generally accepted its decision would be reconsidered.

The staff has applied these principles to the current proposals as to changes in the form of the balance sheet. It was agreed, however, as in the case of the profit and loss statement, that no objection would be made to the filing with the Commission of financial statements prepared in a form other than that required by Regulation S-X, *provided* that such statements were not misleading and were furnished as supplementary data and not in lieu of the prescribed statements.

A common form of the single step statement begins by grouping all "revenues" from which is deducted a single total of costs and expenses itemized to show components of employment costs, materials and services purchased, provision for depreciation, interest charges, sundry taxes, and federal income taxes and arriving at "Income for the year" from which dividends are deducted leaving "Income Retained in the Business." A variation of this form introduces the beginning and ending inventories in the determination of "Costs allocated to the year."

The criticism of a New York security analyst published in the *Journal of Accountancy* for November, 1947, applies to both of these forms. He said:

> At least the main items of cost, wages, materials, selling, distribution, and administrative expenses, might well be listed separately in corporate annual reports. This enables important operating and expense ratios to be calculated, year-to-year trends noted, and comparisons to be made with similar ratios of other companies in the same line. Such comparisons greatly aid in distinguishing the most efficient from the least efficient and high-cost enterprises. Of late there has been a deplorable tendency on the part of some major corporations to lump together "cost of goods sold" and "operating expenses" and to omit entirely the 'gross profit from operations.' One or two steel companies in the past year or two that previously provided a fair amount of detail in this respect, have recently lapsed. The analyst is not enthusiastic about such tendencies.

Having in mind the source of this comment and the fact that in the Commission's administration of the Securities Acts we are required to insist upon financial statements which will be most useful to investors, I think it is clear that the forms presented above are unsatisfactory in several respects. Both statements fail to differentiate between recurring and non-

recurring income (assuming the latter was present) and between investment and operating income. In the second example interest expense is netted against interest income and the balance listed as an offset to "costs incurred." In the first example there is no indication of how the increase or decrease in inventories has been handled and both are obscure as to the items which constitute the cost of inventories and cost of goods sold. There is a possible inference, particularly in the second example, that all items listed as costs incurred may enter into the cost of inventories. This is not a too farfetched assumption for examples have come to our attention in which selling, general and administrative expenses have been included in inventories and cost of goods sold. The practice seems to be a carry-over from war contract accounting practice wherein all recoverable costs under the contract were charged thereagainst. With the reconversion to peacetime operations we think this practice is no longer appropriate and the principle of excluding from inventories selling, general and administrative expenses not applicable to production as laid down in the Accounting Research Bulletin No. 29 on "Inventory Pricing" should be applied.

Some of these new style income statements have substituted every-day language (apparently considered to be more understandable to lay readers) for technical accounting terms. The use of "received from customers" and "paid for" elements of cost connotes a cash basis of accounting which surely is not intended. The general idea of simplification expressed in these statements had been used for a number of years prior to the war in special reports prepared for employees or as a basis for "pie" charts or other pictorial forms of presentation in the president's letter. I think this use is appropriate as a supplement, not as a substitute; but before even subscribing to such limited use it should be made certain that the interpretative value of the conventional style of profit and loss statement is not in the process of being subordinated to the anticipated propaganda value of the new style. Nor am I ready to concede that informed stockholders and financial analysts should be confined to a form of reporting designed to meet the needs of those unfamiliar with the terms and principles of corporation finance and accounting. Instead I think we should encourage more investors to learn these principles.

In concluding this consideration of the profit and loss statement it may be mentioned that under the Securities Act our registration forms for mining companies in the developmental and exploratory stage and industrial companies in the promotional stage require the submission of statements of cash receipts and disbursements instead of profit and loss statements as in most such cases the latter would be much less informative than the former. We also have under consideration the extension of this idea to annual reports for such companies.

Experimentation with new forms of statements of financial condition as substitutes for the balance sheet is not new, for companies in the developmental stage. The reshuffling of the balance sheet for large and well established corporations, however, seems to be a more recent development. Generally speaking we have the feeling that the narrative form violates the principle that specific liabilities, or classes of liabilities, as a rule are not claims against specific assets or classes of assets. The problem is not particularly serious in a company which is not only financially sound but in which all liabilities are current and are exceeded substantially by the current assets. We have more difficulty as the margin grows narrow and question entirely the propriety of the narrative style when long term debt is present. Occasion-

ally a form of debt crops up that is difficult to classify even on a balanced form of statement. In such cases the narrative form may give a definitely misleading result.

A statement of changes in working capital or sources and application of funds I think is a useful form of presentation in connection with the balance sheet as well as with the narrative form of statement. In fact the changes in working capital seem to me to demonstrate the weakness of the latter form as they necessarily set forth that in addition to net income as reported the sources of working capital are reflected in all areas of the balance sheet—conversion of plant assets through depreciation or sale, disposal of investments, long term loans and issues of bonds and stocks. Conversely reductions of working capital may come from losses in operations, expenditures for plant or investments, repayment of loans, retirement of bonds and capital stock and the payment of dividends. This flow of funds within the business I believe can be visualized more clearly and with less danger of misinterpretation by means of the balance sheet form than can be done in the narrative statement. It seems to me, therefore, that the narrative form is inappropriate except in the simplest situations.

In closing I should like to emphasize the importance to the SEC of the necessity for presenting clearly to the investing public the financial status and progress of the nation's industry. It is the underlying philosophy of the various Securities Acts that financial statements shall be so prepared as to make it possible for individuals to determine on their own account whether to entrust their investable funds to the management of a given corporation or to increase or decrease their present investments.

While the Commission has broad powers with respect to the determination of the accounting principles upon which financial statements filed with it shall be based—powers which to a large extent it has never exercised—it does not to my knowledge, have the power, and most certainly does not have any desire, to advise the investing public concerning the merits of any security.

It is imperative, therefore, that the Commission make certain that the financial statements contained in registration statements be completely unequivocal and are not used as a proving ground for innovational presentations.

This does not mean that we are against the adoption of new forms of presentation or the establishment of new accounting principles, should those presently in use prove to be outmoded. We do feel, however, that any major changes in basic principles or in the form or content of the income statement or the balance sheet should be made only after the entire accounting profession has given serious consideration thereto and is willing to endorse them without reservation or exception.

TOWARD A SYNTHESIS OF ACCOUNTING DOCTRINE

Gordon W. Stead

Accounting has rightly been said to perform a service function. It exists to serve commerce, industry, and government. These three branches of economic endeavor are constantly evolving into new forms with new content and new orientation.

It would thus appear to follow that, in an effort to distill principles of accounting out of the myriad rules of thumb of practice, the subject must be placed in its historical context and those features of it which might change with the form of economic organization differentiated from those which are unlikely to do so. An example in this connection is the change in attitude toward the balance sheet which has taken place over the past one hundred years. Originally it was addressed to the creditors of a firm and provided their only guide to solvency.[1] Hence the emphasis on such notions as "cost or market, whichever is lower." Nowadays this function is performed by credit-reporting organizations, while the modern corporation seeks the bulk of its financing otherwise than by current liabilities, permitting the substitution of the "going concern" approach for that of possible liquidation. It may be that the future will bring more reliable index numbers and thus, perhaps, stabilized accounting, as H. W. Sweeney proposes.[2] Many other suggestions could be used to illustrate the point that the future will bring new problems for the accountant.

Will he be able to meet this challenge? In the last few years there has been a concerted effort on the part of the two major accounting associations to lay down rules of procedure which, it is hoped, will be followed by the profession in an attempt to bring about uniformity. This is undoubtedly a most commendable objective. There is, however, a tendency for rules once laid down to assume a rigidity that precludes their meeting the tests of time. Such, for example, was the case with the Common Law of England, which had to be supplemented by Equity in order to insure that justice was done in the new context.

Furthermore, the attempts to arrive at principles of accounting have so far been mere compilations of "good things" in the *present* context, drawn, as it were, out of thin air, without any regard for their functional relationship or historical validity. It is true that these lists have been arranged in what was thought to be an order of merit, but neither the order nor the content has received any marked degree of general acceptance. The numbers thereof have ranged from six to twenty-five and the content all the way from immutable laws to trifling rules of particular conduct. The greatest area of agreement lies in the practical rules, but these have often been criticized by the profession for their lack of flexibility. This is a criticism in space analogous to mine in time.

What follows is an attempt to synthesize previously expressed views and to sort out the obvious confusion that presently surrounds the search for principles. It is intended as a first approximation and to be considered neither final in form nor exhaustive in content. It is offered as a device

[1] For an idea of the problems and atmosphere of an earlier day, see two articles by Bishop C. Hunt, "The Joint-Stock Company in England, 1800–1825," and "The Joint-Stock Company in England, 1830–1844," *Journal of Political Economy*, February and June, 1935; also Geoffrey Todd, "Some Aspects of Joint-Stock Companies, 1844–1900," *Economic History Review*, October, 1932.

[2] H. W. Sweeney, *Stabilized Accounting* (New York: Harper, 1936).

for clarifying our thinking by setting down in organized fashion those "principles" which are undoubtedly implied in all that has been written on the subject. I believe it would help to have implied principles made explicit, and not merely as an unrelated catechism for today only, but by showing the derivation of rules of conduct (which may be subject to change with changing circumstances) from immutable principles.

In order to eliminate from the present discussion the dictionary confusion[3] as to the meaning of terms used, it is proposed to use the following words in the ways indicated, each of which has dictionary sanction:

Principle: in the sense of an invariable cohesive force;

Canon: in the sense of a goal derived from the principles;

Standard: in the sense of a measure against which conduct must be squared;

Rule: in the sense of a detailed mandate in a particular case;

Doctrine: the whole body of principles, canons, standards, and rules.

Instead of starting at the bottom of this hierarchy (the practical rules), or somewhere in the middle (a list of unrelated so-called "principles"), it is proposed to start at the top with one fundamental concept and to derive the other layers therefrom in succession, because I believe that this is the direction of causation. Rules of particular conduct exist because they bring about fulfillment of a higher principle; the principles do not exist to justify the rules.

It seems to me that the one quality which distinguishes the accountant from the mere bookkeeping minion is Integrity, because the former alone is called upon to exercise judgment. The accountant, by whomsoever employed, partakes of the character of an umpire or an interpreter between management and the shareholders, bondholders, and other creditors, between management and labor, between management and the government and its agencies, and between management and the consuming and investing public.[4] He is relied upon to determine and to present "the facts," on the basis of which decisions may be made. He has also, of course, the analogous reportorial function of interpreting the business as an economic organism to its own management, and thereby to provide the basis of internal policy decisions.

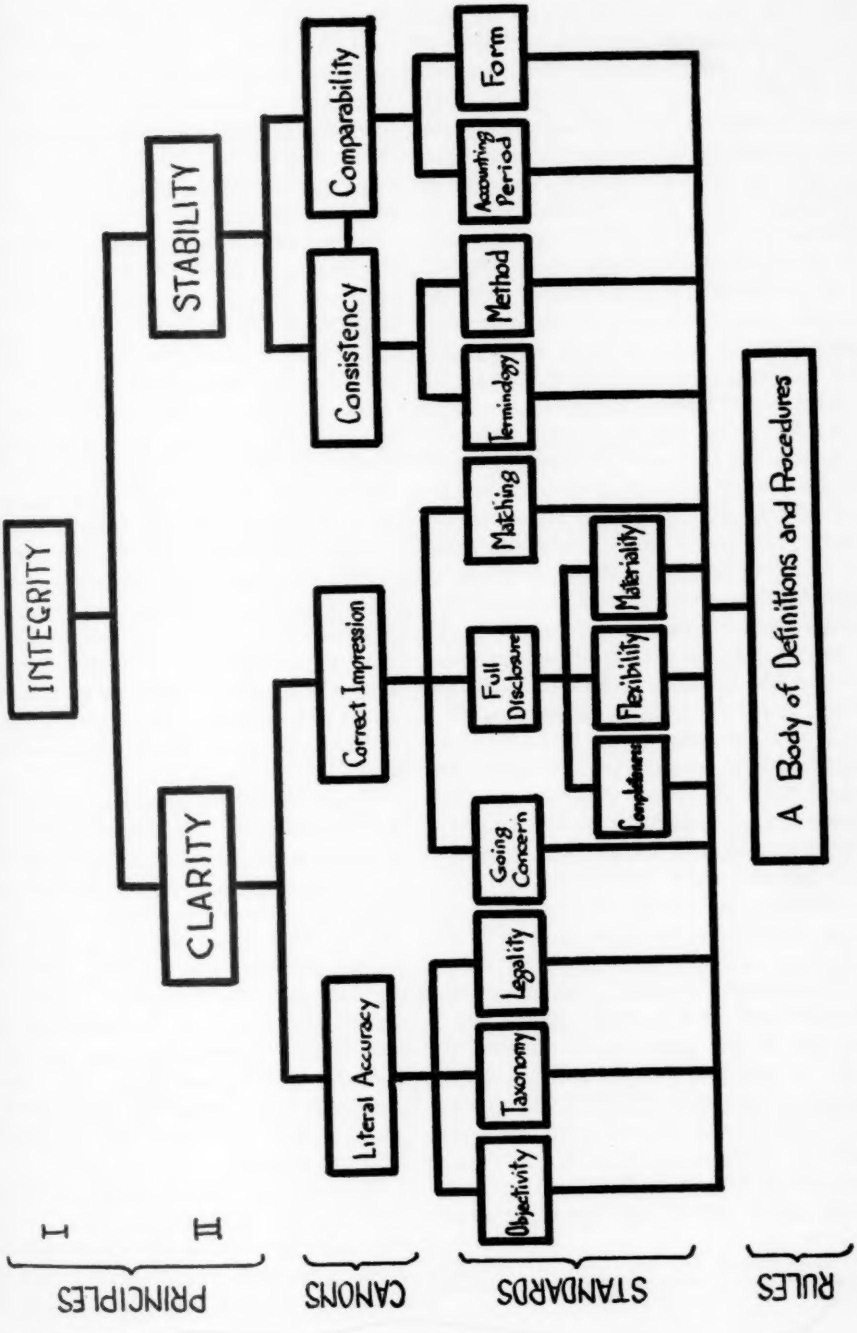
Now this high duty is clearly an ethical one, for the accountant must decide what is the "right," the "fair," the "sound" answer. Furthermore, although principles are commonly regarded as immutable and business ethics *do* change, the principle is not thus invalidated, for although what constitutes integrity may change, the fact that the accountant must acquit himself with integrity, whatever that may mean at the time, is invariable else his value disappears.

Integrity, then, is the one all-pervading principle of accounting. It will be rightly objected that this is an unmanageable concept, or, in other words, that its particular meaning in a case of detail is obscure. This is merely a matter of subdividing the concept into its integral parts, which I have chosen to call Clarity and Stability (of decision, not of results). Further subdivision makes our objectives more clear. To these concepts the name of canons has been given. By continuing this process standards are evolved and from them detailed rules of procedure as indicated in the accompanying chart.

Some comments may perhaps assist in making the meaning clear. Desirable as literal accuracy may seem to be in endeavoring to fulfill the principle of clar-

[3] Stephen Gilman, *Accounting Concepts of Profit* (Ronald Press: New York, 1939), Chap. 13.

[4] See also Samuel J. Broad, "Why Do We Need Accountants?" *Journal of Accountancy*, October, 1945.


INTEGRITY
STABILITY
CLARITY
Comparability
Consistency
Correct Impression
Literal Accuracy
Form
Accounting Period
Method
Terminology
Matching
Materiality
Full Disclosure
Flexibility
Completeness
Going Concern
Legality
Taxonomy
Objectivity
A Body of Definitions and Procedures
I
II
PRINCIPLES
CANONS
STANDARDS
RULES

Doctrine

ity, that alone often obscures the main picture by sheer weight of detail and may mislead by virtue of the fact that readers of statements may be thinking in different terms than its authors and may have widely varying knowledge of the business in question or of accounting. Thus the accountant, to be fully truthful, must also endeavor to create the correct impression in the mind of his particular audience.[5]

In connection with the first of these two canons, literal accuracy, I have in mind the following types of rules which might be their end product. Objectivity, for instance, might be said to give us the use of the dollar as the unit of account, either stabilized or not; the use of realization or production as the criterion of revenue; and the use of original cost as the criterion elsewhere. Taxonomy (the laws and principles of classification) would lead to a set of classifications accurately defined and their content determined and publicized in such a way as to admit of as few interpretations as possible by those called upon to use them, either as authors or readers. This leads to a discussion of the standard of legality, which would give us rules that would result in proper statement presentation of such matters as creditor priority, stated capital, and the like in conformity with law and which would insure that the content of classifications having a meaning at law would have the same meaning in accounting.

The standard of creating the correct impression necessitates at the present time the use of the going-concern approach, since far and away the largest groups of readers of statements think in these terms unless there is an express purpose to the contrary, such as the case of statements prepared by receivers. This logically leads to the use of rules of objective criteria discussed above, for example, since monetary market values of many assets are of little interest where the concern in question does not contemplate immediate sale, such values perhaps being included parenthetically if at all. Full disclosure is essential to creating the correct impression in that most readers of statements assume it. This further implies some contradictory ideas. It clearly implies completeness, but this must be modified by materiality to an extent determined by the purpose of the statement. Nor can the correct impression be created by indiscriminate adherence to prescribed rules using classifications and procedures unsuited to an unusual business. Rules derived from this group of standards would be the result of weighing the pros and cons of such considerations as treatment of contingencies, the degree to which detail may be obscured and the degree of conformity to specified forms which is advisable for various industries. The notion of matching costs and revenues, leading to rules dealing with the accrual basis, is, I think, in accordance with the preconceptions of most people concerned with financial statements.

Under stability of decision, consistency is intended to refer to that of terminology and method at a time, while comparability has to do with the same desiderata over time and covers the convention of the regular accounting period and relative rigidity of form (and, clearly, content of each classification therein). These two canons are, of course, related. Under this head would also appear rules prescribing conduct should exceptions to other rules in particular cases be considered advisable. These might take the form of requiring full explanation.

The practical rules of conduct which follow from the standards may do so from all or from some of them. It may be that this involves resolution of conflicts among the standards, but, at least it helps to be

[5] See, for example, Don Knowlton, "The Semantics of Annual Reports," Accounting Review, October, 1947.

aware of the values being balanced in arriving at rules.

I have not considered it necessary to distinguish between those parts of the doctrine which apply to the keeping of records and those which apply to financial statements. This is because I regard the two elements as essentially one whole and because this is the province of those engaged in laying down the detailed rules, which I have confined myself to merely indicating.

It should be noted that this synthesis is anchored at the top and change is contemplated over time in increasing degree as one descends the pyramid. The value of this approach is conceived to be the ability to derive the lower orders from those immediately above and thus constantly to check any formulation in any ethical framework against the dicta from which it is supposed to stem, thus aiding in clarifying one's thought in the first instance and preventing ossification over time.

SUGGESTIONS TO THE COMMISSION ON ORGANIZATION OF THE EXECUTIVE BRANCH OF THE GOVERNMENT

HOWARD W. BORDNER

THE CREATION OF the Commission on Organization of the Executive Branch of the Government by authority of the Congress of the United States is but one of many attempts to reorganize extensively the Executive Branch of the United States Government. The Commission is composed of twelve members representing the President of the United States, the Senate, and the House of Representatives; it is bi-partisan in character. Ex-president Hoover is Chairman of the Commission, and the other eleven members also are eminently qualified to discharge the great responsibility placed upon the Commission.

The Commission is required to study and investigate the present organization and methods of operation of all departments and establishments of the Executive Branch of the government and to report thereon, with recommendations for changes, to the Congress, convening in January, 1948. The declared objectives of the Commission are as follows:

(1) Limiting expenditures to the lowest amount consistent with the efficient performance of essential services, activities, and functions;
(2) Eliminating duplication and overlapping of services, activities, and functions;[1]
(3) Consolidating services, activities, and functions of a similar nature;
(4) Abolishing services, activities, and functions not necessary to the efficient conduct of government; and
(5) Defining and limiting executive functions, services, and activities.

Thus, the scope of the Commission's work is intended to be as broad as the organization and activities of the entire Federal Government. A year is a very short time for such work.

Although the current budget of the United States Government covers proposed expenditures of approximately 40 billion dollars, a very large part of these expenditures have to do with national defense, aid to veterans, interest on the public debt, and aid to war-torn Europe. It is not to be expected, therefore, that the Commission will be able to make suggestions that if effectuated would result in any tremendous reduction in expenditures. Yet in such great and diverse activities as are conducted by the government, the overhead costs of administration are significant. A reduction of such costs is important, but of equal or greater importance is the doing of a better job in the conduct of government operations in order better to serve the public interests in world peace and in domestic tranquility.

Accountants familiar with accounting and methods of operation in the Federal Government are in a position to make some contribution to the work of the Commission. It has been the general opinion of accountants and businessmen familiar with modern accounting and methods of doing business in large private corporations that the Federal Government suffers severely by comparison from the standpoint of economy of conducting operations and the general effectiveness of management. In respectfully submitting the com-

[1] It may be observed that the elimination of duplication of services is not the equivalent of the centralization of similar service activities for all departments and establishments, although there is often confusion in this regard. Many services may be rendered more effectively and economically on a decentralized basis. For example, it is generally recognized that each department and establishment needs a separate personnel service.

ments and suggestions in this paper, the writer is guided largely by what he believes are standards in private industry—standards that are superior to those found in the Federal Government. The comments and suggestions herein are confined largely to the use of accounting as a tool of management, organization of the accounting function, and the question of the manner in which financial transactions are carried out; very little is said with respect to detailed accounting and reporting procedures, although much more could be said in that respect. Also in this discussion it is believed impossible to forego some comments on the personal equation in management, because it is believed there has been a tendency to ignore it in the Federal Government.

MANAGEMENT RESPONSIBLE FOR ACCOUNTING

The management of each major activity must be considered to be primarily responsible for the accounting of that activity. The reasons are as follows: (1) All accounting data must originate at the source of transactions—the financial aspects of transactions cannot be divorced from the operations for which the agency is responsible; (2) to be of greatest use to management in operations it is necessary that it have timely, accurate accounting information in usable form—this is necessary and usually indispensable in the conduct of operations as well as in the reduction of operating expenses; (3) the management of the activity must be held responsible for giving an accounting covering the discharge of their responsibilities, showing accomplishments as well as costs, especially in relation to goals or standards initially set through budgetary plans;[2] and (4) budgetary planning must originate with the responsible activity as the basis for obtaining funds to carry on the activity.

The foregoing suggestion is consistent with the basic management philosophy that decentralized management is necessary in large-scale activities. Large business corporations have found that centralized operation of large diverse activities is not only more costly, but generally is quite ineffective.

It will be noted that accounting is considered to include budgetary planning as well as accounting for individual transactions and reporting on the results of operations. Unfortunately, contrary to the practice of well-managed business corporations, budgeting in the Federal Government is considered to be separate from accounting. Budgeting involves the same type of measurements as historical accounting—the two phases of accounting (planning and reporting of actual results in relation thereto) must be tied together to be of value.

In stressing the importance of accounting at the activity level, it is not intended to imply that an individual activity should be subject to no restraint or control; that subject will be dealt with below.

NEED FOR A SINGLE TOP ACCOUNTING AGENCY

There is no single top accounting agency or authority in the Federal Government. This function is shared by the Treasury Department, the Bureau of the Budget (both in the Executive Branch), and the General Accounting Office (in the Legislative Branch).

[2] This conception of accountability is broader than that common in the Federal Government in that: (1) The top executive of an agency is considered to be the person primarily accountable, rather than a subordinate disbursing officer, and (2) the terms of accountability extend beyond mere accounting for funds, and the disbursement thereof pursuant to law, to the accounting for operating results, including costs in relation to accomplishments. Subordinate executives are of course similarly accountable to their superiors. This conception of accountability also is of greater value in the control over operations by the Congress as well as by the President of the United States.

It is suggested that the duties and functions of a single top accounting agency in the Federal Government should be as follows:

(1) To prescribe standards on a broad basis for all accounting functions of the various departments and establishments of the Federal Government. This includes preparation of budgets, manner of conducting financial transactions, bookkeeping procedures, cost accounting, methods of accounting control over assets and costs, statistical measures of accomplishments, accounting principles to be followed, and reporting.

(2) To exercise the present functions of the Bureau of the Budget in the compilation of the over-all Federal budget under the supervision of the President of the United States, and to make such studies as may be required by the President or the Congress in connection with the development of financial and operating plans, with the cooperation of the various departments and establishments.

(3) To render periodic over-all reports of the Federal Government as a whole, based upon consolidation of the accounting reports of the individual departments and establishments, showing the financial position of the Government and its results of operations—particularly in relation to budgetary plans.

It will be noted that the foregoing outline does not provide for duplication by the top accounting agency of functions of the individual departments and establishments, but it does provide for requisite supervision and coordination in so far as accounting is concerned; furthermore, it provides for the conduct of accounting above the departmental level for the government as a whole. Such a plan is already exemplified in part in the new National Military Establishment in its relation to the subsidiary Departments of the Army, Navy, and Air Force.

In prescribing methods, procedures, etc. the top accounting agency should not interfere with the accounting requirements for management purposes in the separate departments and establishments; they should be left as free and flexible as possible to meet their individual requirements. There is too great a tendency in the Federal Government on the part of supervisory agencies, such as the proposed top accounting agency, to be unduly detailed and rigid in their requirements. In all fairness it should be remarked that this tendency is consistent with the general spirit of the legislation affecting these matters, and that reform in this connection should begin in legislation. More will be said later with respect to certain aspects of this matter.

There is some question as to where the proposed top accounting agency should be placed in the Executive Branch. There is no doubt but that the agency should be considered to be at the highest level of management in accordance with the practices of large business corporations—in no other way can this agency have the stature that is required in order to enable it best to serve the Executive Branch. Because it would be fully as important in the operations of the Executive Branch as the Treasury Department, there is every reason why it should be coordinate in rank; therefore, its head should be a cabinet member. It might be objected that the general accounting agency would be only a service activity for the government as a whole, but such an observation can also be made with respect to the Treasury Department; both are extremely important services. As an alternative, the agency could be considered to be a part of the President's Office in the same manner as the Bureau of the Budget is presently established; it appears that the only difference in these alternative positions consists in the degree of importance in the government that is to be occupied by the agency; certainly there would be real stature for the agency in either position.

It is desirable to review briefly and

broadly the present allocations of the top accounting functions in the government and to consider certain deficiencies following therefrom.

The Treasury Department is primarily responsible for conducting the government's banking operations, including the handling of receipts, funds, and disbursements; the assessment of taxes; the management of the public debt; and the management of the currency and coinage (there are of course numerous other activities). In connection with its responsibilities for handling the funds of the various departments and establishments of the government, the Treasury undertakes responsibility for compilation and reporting of data with respect to receipts and disbursements; furthermore, in such connection the Treasury cash accounts are so established as to provide a basis for the prevention of overdrawals of individual appropriations by the respective departments and establishments—on this account the Treasury duplicates a great deal of the departmental accounting.[3] In addition the Treasury Department renders certain over-all annual financial statements compiled in part from data submitted by the departments and establishments. It is believed that the Treasury's responsibilities for fiscal operations are so great that its undivided attention thereto would be desirable; moreover, the accounting responsibilities are so great that they require special, undivided attention of a top agency. No businessman would expect his banker to keep his accounts to his satisfaction. Again it is desirable to simplify Treasury accounting and eliminate the duplication that exists between the Treasury and the departments.

The importance of one accounting function—budgeting—resulted in the separation of the Bureau of the Budget from the Treasury Department and its attachment to the President's Office. There was no good reason for separating this function from other accounting functions; all of the over-all accounting functions should have been likewise detached and maintained intact in one agency. As a result of the separation of the Bureau of the Budget, top accounting regulation and supervision in the government requires the joint cooperation of the Bureau and the Treasury Department. This is further complicated by the power of the General Accounting Office to prescribe methods of cash and fund accounting;[4] this requires three-way cooperation in that aspect of regulation.

While the General Accounting Office is primarily an independent auditing agency responsible directly to the Congress and not a part of the Executive Branch of the government, it has certain responsibilities that are believed to belong properly to the Executive Branch; these responsibilities do not have to do with auditing. It is suggested that the General Accounting Office should not have power to prescribe methods of accounting because such power is necessary to a proper use of the accounts in operations by the managements of the respective departments and establishments; the suggested top accounting agency in the Executive Branch may more properly serve as a coordinating and supervising agency. It is also suggested that the General Accounting Office should not have the power to disallow expenditures of the executive departments and establishments because this power infringes upon the powers that should rest in the Executive Branch of the government if that branch is to be held fully accountable for operat-

[3] Triplicate appropriation and cash accounts are carried in the General Accounting Office. See page 367.

[4] The Independent Offices Appropriation Act of 1948 carries a rider providing that the General Accounting Office also shall have the duty of prescribing or approving methods of accounting for property and inventories. This power does not extend yet to other departments and agencies. Here is just one example of how accounting matters are dealt with incompletely on a piece-meal basis.

ing results.[5] Moreover, the Constitution provides that the Chief Executive shall be responsible for the enforcement of all laws. The power of reporting by the Congress' auditing agency is believed to be most effective as a means of check on management by the Congress.

SUGGESTIONS FOR IMPROVEMENTS IN AUDITING

While the General Accounting Office is an agency of the Legislative Branch, it is impossible to disregard its functions in any study of accounting in the Executive Branch of the government, expecially as to the placement of certain responsibilities and avoidance of duplication of effort. The suggestion has just been made that the powers of prescribing methods of accounting disallowing expenditures do not properly pertain to auditing. It is desired also to make certain comments with respect to the audit responsibilities of the General Accounting Office in part from the standpoint of the placement of responsibilities between the Legislative and Executive Branches and in part from the standpoint of indicating that greater benefits may be obtained from independent auditing.

The use that should be made of independent audits in the government may be considered parallel to their use in private business. The Congress is justified in having an audit and investigative agency to keep it fully informed regarding the discharge of responsibilities in the Executive Branch, but it is believed necessary to change certain auditing conceptions in the government in order to obtain the greatest value from independent audits; these conceptions are reflected in laws in which changes would have to be made to enable the suggested changes in auditing to be effectuated.

In its auditing of government operations, pursuant to present laws, the General Accounting Office now is primarily concerned with cash transactions, with emphasis on cash disbursements. Attention is given largely to the legality of transactions; this comprehends a great deal including whether the transaction is authorized by law, whether it is covered by an appropriation (in the case of disbursements), and whether in all other respects it is consistent with restrictive statutes governing financial transactions of the government, including the manner of making expenditures. The General Accounting Office is not specifically responsible by law for auditing transactions involving property or commodities.

A principal feature of the transactions audit is in the personal accountability of Treasury or departmental disbursing officers for the legality of transactions as well as fiduciary responsibility for transactions and fund balances, although as provided by law their responsibility for transactions is subject to their right to rely upon certifications by departmental certifying officers who are made legally responsible for the transactions certified. Illegal transactions are "disallowed" by the General Accounting Office, and become a charge against the accountable officer or his bondsman. The accountable officer may have, in his turn, a right of recovery against the person to whom the disbursement was made. This is an extremely powerful tool in enforcing compliance with the laws of the Congress, but it is doubtful that it is necessary and it is certainly subject to serious disadvantages from an operating viewpoint; in this connection the following comments are offered:

(1) The accountable officers are at a relatively low level. They should not be expected to relieve their superiors of responsibility. [6]
(2) The rigidity of the system permits no recognition of exceptions nor special consideration of materiality of specific transactions, thus providing a source of petty

[5] See below for further discussion of this subject.

annoyance and a serious and costly impediment to efficient operation.

(3) It is believed that the cost of this type of control is far in excess of the value of the benefits.[6]

(4) This control is a part of the indirect method of Congressional discipline of departmental and agency chiefs which may be criticized as being less desirable than a direct method and not in the best interests of the government.

It is believed that the auditing activities of the General Accounting Office should be on a higher level, including an examination of the effectiveness with which operations are conducted by the various departments and agencies.[7]

Since fraud should be prevented (mere detection is inadequate), the departments and agencies should be held primarily responsible for adequate internal organization to prevent fraud and irregularities, in which event the General Accounting Office should not be required to make extensive detailed audits of transactions.

The higher type of audit should also deal with the question of adequate and true reporting on activities on the basis of accomplishments as well as costs. This type of audit would be required to be conducted in the offices of the departments and establishments. A start in this direction has been made in the auditing of government corporations; the Government Corporation Control Act now provides for a commercial-type audit of government corporations, and the policies initially established in such audits generally conform to the foregoing suggested pattern—what is good for the goose is good for the gander[8]—these policies should be made applicable to the normal departments and establishments.

In order that there would be no misunderstanding of the functions of the

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[6] Section 205 of the Legislative Reorganization Act of 1946 authorizes and directs the Comptroller General to make a full and complete study of restrictions placed in general appropriation acts limiting the expenditure of specified appropriations therein with a view to determining the cost to the government incident to complying with such restrictions, and to report to the Congress his estimate of the cost of complying with such restrictions and such other recommendations with respect thereto as he deems necessary or desirable. This study would cover only part of the excessive costs resulting from over-regulation referred to above. To date the report of the Comptroller General has not been filed. It may be remarked that the estimation of such costs is very difficult.

[7] An examination of effectiveness of operations of each department and agency is required of the General Accounting Office by section 206 of the Legislative Reorganization Act of 1946, but an appropriation for such an examination during the fiscal year 1948 was withheld by the Congress. Such an examination should be of immense aid to the Appropriations Committees; however, there should be no duplication of efforts required of the General Accounting Office and the Committee staffs.

[8] The only legitimate excuses for the existence of government corporations relate to their temporary uses in obtaining better management of government activities. The principal ways in which this form of government agency has contributed to better management are as follows:

(1) The decentralization of the corporate management, to the extent autonomy is not compromised, results in more effective administration, especially in the case of business-type activities, because complete authority is delegated to do a job without interference.

(2) There are certain advantages in entrusting policy-making and over-all supervision of important activities to a Board of Directors (usually part-time) in the corporate pattern as distinct from a single administrator while still retaining the advantages of a single chief executive of the activity in directing actual operations. Congress cannot take responsibility for detailed policy making although it can and should retain responsibility for major policies. In this sense a Board of Directors serves as an alter-ego of Congress. (However, in practice, government corporations have not usually operated upon this basis.)

(3) The cumbersome appropriation procedures are avoided, including the burdensome accounting and auditing requirements with respect to cash transactions. (It is not believed to be desirable to eliminate all appropriation control in the case of activities which are not self-supporting.)

(4) The corporations are freed largely from requirements to operate in accordance with the restrictive statutes.

(5) The corporations have greater autonomy with respect to Civil Service than ordinary departments and agencies. This advantage has now largely disappeared.

The corporations have been subject to heavy pressure to place them in the mold of ordinary government agencies. It is a question whether or not their enemies may win, to the great detriment of public administration. To the extent that the corporate pattern wins, public administration in the departments and agencies of the Federal Government will be improved. (The corporate pattern may be employed where it is desirable without the corporate entity concept.) The Government Corporation Control Act which provides for business-type budgets as well as audits, shows that the Congress has recognized a new means of control.

General Accounting Office, it is suggested that the name should be changed to General Auditing Office, and the title of the head of the agency changed to Auditor General of the United States.

It should be noted that the proposed functions of the top accounting agency in the Executive Branch of the government do not include the duty of auditing the individual departments and establishments of the government to determine their compliance with laws and regulations to the extent that such compliance shall not be self-evident from reports of the departments and establishments. It already has been suggested that responsibility for the fiduciary integrity of the accounts should be at the departmental level with adequate internal organization at that level in order that responsibility may be discharged best and fraud and irregularities prevented. The audit reports of the Congress' auditing agency should be used by the top Executive accounting agency in its supervision of accounting of the departments and establishments. To be of value in this connection audit reports should be timely; they should not be rendered a year or more after the period they cover.

LEGISLATIVE RESTRICTIONS ON THE MANNER OF CONDUCTING OPERATIONS

The Executive Branch of the government is subject to hampering and annoying legislative restrictions as to the manner of conducting its operations at the transactions level. In part these restrictions are made in appropriation acts, but there is also a considerable body of the so-called "prohibitory statutes." While there may be adequate justification for Congress' attention to some of these matters, when they are dealt with in a detailed manner on a statutory basis an undue rigidity tends to result; detailed statutes generally do not permit the use of administrative discretion when insignificant amounts are involved or when there are special circumstances that would justify exception to the general rule. It is believed that the impediments to necessary action and the excessive efforts required to operate within or around these restrictions constitute too high a price to pay for the degree of control resulting therefrom.

For example, section 3709 of the statutes requires advertising for bids, and presumably the award to the lowest bidder in the purchase of any goods, supplies, or services. (Its use was suspended to a considerable extent during the war emergency.) This procedure is frequently unnecessary and often more expensive in time and effort than is justifiable to serve the basic purposes of the requirements. The basic purposes to be served are: (1) To purchase goods and services at the lowest possible cost; and (2) to prevent favoritism to individual suppliers. Good purchasing agents can meet both of these objectives substantially in "mine-run" purchases without rigid, formal procedures through their day-to-day contact with the usual sources of supply, and in many instances of such purchases the question of favoritism cannot possibly apply.

It is believed that better control would result in these matters if the Congress would make these restrictions in the form of pronouncements of policy, rather than through minute, detailed, rigid restrictions, thus giving more administrative discretion to the Executive Branch. For purposes of control, more attention might well be devoted by the Congress to the following.

(1) Clear definition and fundamental limitation of activities to be authorized for every department or agency of the government together with pronouncements of broad policies governing operations.
(2) Giving necessary operating autonomy to the Executive branch of the government with freedom from detailed restrictions.
(3) Insistence by the Congress upon complete audit reports by the General Accounting Office on every department and

agency including a report on the effectiveness with which operations are conducted. Such audits should be required to cover current budgets as well as past operations —the reports should be timely in order to be of any use.

(4) The Congress should expect strict accountability for results as well as for costs on a broad basis by every department and agency.

(5) The development of a career management class in government independent of both civil service and political appointments should be fostered. (See page 370.)

ACCOUNTING FOR EXPENDITURES FROM APPROPRIATIONS

Accounting now required for expenditures from appropriations is a very cumbersome matter. Such accounting is the very basis of all Federal Government accounting.

As has already been noted above, appropriation and cash accounts are carried not only by each agency but also by the Treasury Department and the General Accounting Office. This follows from the theory that there must be an independent preventive check to keep the agency from overdrawing its appropriations or exceeding its limitations. In connection with this accounting, the methods of making funds available to the departments and agencies through "warrants" and "requisitions" is unnecessarily complex. It would be much simpler and much more economical to place the entire responsibility on each agency for accounting for disbursements from appropriations, thus eliminating not only the accounts of the General Accounting Office and the entire warrant system, but also simplifying the system by greatly reducing the number of accounts carried by each agency with the Treasury. Under this system, the Treasury Department would merely make available to each agency the combined aggregate amounts of the appropriations thereto.[9] Reports of the various agencies and post-audits thereof by the General Accounting (auditing) Office would serve to disclose malfeasance by agency officials—and after all, with responsible management why should there by any expectation of malfeasance? If malfeasance occurred it should be severely punished.

There is one important reform necessary in the present classification of appropriations and expenditures therefrom. In many agencies, the classification of expenditures does not begin to coincide with or parallel the administrative organization units and separate activities of the respective departments. In consequence, the operating expense accounts of such agencies (which parallel the separate appropriations) are entirely unsatisfactory for the purpose of managerial control of organizational units and activity units. Although not subject to the usual type of appropriation control, Tennessee Valley Authority has employed an exemplary classification of accounts of this type. It is understood also that the Navy Department presented a revised budget of this type in connection with its request for appropriations for the fiscal year 1948, but its use was not adopted by the Congress.

The requirement to account separately for appropriations for an agency for each fiscal year in accordance with the date of incurring obligations thereunder necessitates keeping appropriation accounts open after the fiscal year has closed. It would be much simpler and more economical, and at the same time would serve all necessary control purposes, if appropriations were made and accountable upon the normal

[9] While it is suggested that each department or establishment have its funds appropriated in one consolidated amount, it is not suggested that the Congress should yield the right and duty to place limitations on the many phases of expenditures. However, such specific limitations and authorizations *do not require the establishment of separate funds for each. The suggestion may be made that expenditure control can be strengthened by greater attention to limitations of costs of specific programs or activities*, rather than catch-all objective classifications of expense (such as personal services for all programs and activities of a department).

accrual basis used in private industry; upon this basis expenditures are reflected in the period in which the goods or services are actually received (rather than ordered) and the expenditure accounts may be closed promptly each year.[10] Technical difficulties in making appropriations and authorizing obligations in connection with such a system are not insurmountable, and should be justified by the savings in accounting costs and greater simplicity in accounting reports.

It is suggested that the whole system of quarterly apportionments of funds through the Budget Bureau is unnecessary and cumbersome. (This is no criticism of procedures for allotment of emergency funds of the President.) In accordance with the proposal that each agency should be responsible for accounting for its appropriations, the agency alone should be responsible for the allotment of funds in such a manner that it will live within its appropriations. The audit of the General Accounting Office provides a means for ascertaining that this responsibility is effectively discharged.

The appropriation procedures for activities of a commercial type which are wholly or largely self-sustaining may be greatly improved, through permitting the activity to use its revenues for its expenditures, rather than requiring the revenues to be "covered into the Treasury" and the expenditures to be made from separate fixed appropriations. The latter procedure is unsatisfactory because of its rigidity; it should be permissible to expand the volume of activity, with increase of both revenues and expenditures, *if their relation is satisfactorily maintained in accordance with predetermined policies, limits, and budgetary plans.* Under the recommended procedure, such a commercial-type activity might receive an appropriation for its anticipated loss to augment its revenues in order to balance its expenditures, but otherwise the activity would operate with a revolving fund. (The appropriation for operating losses is a part of Congressional control over the operation.) Budgetary control for this type of activity is possible under procedures for commercial operations; a revised plan of budgeting of this type was adopted in the Government Corporation Control Act for use in the control of government corporations. It should not be necessary to have a corporation merely to obtain the benefit of the commercial type of accounting control.

The rule of the Congress that all appropriations must be considered by the Appropriations Committees separate and apart from authorizing legislation often results in a very unsatisfactory situation with respect to emergency legislation. In consequence, subterfuges have been authorized in legislation that have resulted in entirely short-cutting the Appropriations Committees, and in some cases in loss of Congressional control over expenditures. Examples of these subterfuges are as follows:

(1) Reconstruction Finance Corporation and Commodity Credit Corporation have been permitted, without appropriation or limitation, to pay subsidies to stimulate production, and to cover higher production, processing, and transportation costs (in order to permit prices to be stabilized). Funds for such payment were obtained from the Treasury under blanket borrowing power.

(2) During the war the funds of various departments and agencies available for the construction of war plants were augmented by authorizing RFC and subsidiaries to use its blanket borrowing power from the Treasury to pay for plant construction.

(3) The Congress authorized the Treasury to

[10] The accrual basis of accounting for expenses has been adopted by the Congress in the limitation of administrative expenses of government corporations. See Government Corporation Appropriation Act, 1948. It should also be noted that this method of accounting is superior to the present "obligation" method for purposes of control, in that it prevents the deferment of current appropriations to future years by making it impossible to place purchase orders against current appropriations and specify delivery in future years.

loan funds to Greece and Turkey, in part without advance appropriation from funds borrowed from RFC. These funds in turn had been borrowed by RFC from the Treasury without appropriation.

It is suggested that in emergencies the Appropriation Committees, in participation with the appropriate Legislative Committees, draft complete legislation involving appropriations as well as the authority therefor.

The practice of Congress in authorizing payment of hidden subsidies is bad. While the payment of subsidies may be justified from the standpoint of the public interest, it is undesirable to disguise the form of their payment so that their significance is lost in accounting for their payment. Two forms of hidden subsidies are as follows:

(1) The Federal Land Banks and other corporations of the Farm Credit Administration have been given the use of large sums of government capital, interest free. In large part, these funds have been invested in government obligations the income from which has served to pay for losses from operations, expenses of promoting the growth of Production Credit Associations, and building up the ownership equity of cooperative borrowers in the corporations.

(2) Subsidies have been paid to air transport companies through contracts for carrying mail at rates presumed to be in excess of a reasonable charge (based upon airmail rates charged by the Post Office Department).

It is suggested that subsidies for such purposes should be authorized specifically through appropriations, and accounted for as such—business-type activities should not receive capital funds from the Treasury without requirement to pay interest equal to the cost of money to the Treasury.

OTHER COMMENTS ON ACCOUNTING

Inadequate attention is generally given in the departments and establishments of the government to accounting control over property and inventories. The emphasis on appropriation accounting is no excuse for this omission. This weakness exists in government corporations which are not subject to appropriation accounting and where it is an easier task to integrate all accounting requirements than is the case in the normal departments and agencies. It is obviously impossible to expect centralized accounting for property and inventories in the General Accounting Office or in any other place in accordance with certain recent legislative proposals. The responsibility for this type of accounting can be discharged only by the respective agencies, but such accounting should be subject to over-all audit, which is not required now.

Financial and operating reporting in the Federal Government is in a very primitive stage. The more complex reporting requirements of government corporations engaging in commercial-type activities are now receiving attention, largely as a result of the impetus of the Government Corporation Control Act. However, there are many similar activities carried on without corporations for whom reporting needs to be developed similarly. As has been noted above, improvements in reporting for management purposes requires classification of accounts based upon organizational and activity units; until this change has been made good reporting will lag.

In determining costs of individual programs and activities, all costs should be considered, including indirect costs and the costs of all services utilized by the respective program or activity. From the standpoint of budgetary control of costs, in the broad decisions necessary in weighing the worth of specific programs and activities, it is desirable to know all of the costs entailed by the program or activity—not merely the direct costs. This would require the use of cost-accounting methods of cost allocation. It may be objected that such cost accounting would not bring benefits commensurate with the expense of

accounting. It may be answered that any department executive will be more frugal in his demand for special services if his department is charged for them at cost. However, there is always a line beyond which the benefits of meticulous cost accounting do not justify the expense; this line must be drawn by qualified accountants using professional judgement.

NEED FOR A MANAGEMENT CLASS IN THE GOVERNMENT

As has been found in American business and in all government experience throughout history, there is no substitute in the conduct of government affairs for good management in the operating executives. No amount of restrictive legislation by the Congress will cure the bad effects of poor management.

Qualities that make good managers are extremely rare in human beings. It cannot be said that good managers are born with their fundamental characteristics; rather it is true that good managers are a product of training, and in connection with such training it is necessary that there be adequate incentives. In business the incentive of monetary compensation has been stressed almost exclusively, but other incentives of just as great or greater social value have existed in the outlet that has been provided for other ego drives, such as the competitive instinct, the desire for recognition of personal worth, and the more altruistic desire of obtaining self-satisfaction through service to others.

On the other hand, in government there has been a failure to recognize the need for adequate monetary incentives to management and a failure to provide good management with the proper atmosphere of freedom of opportunity for operation and gaining recognition. Government and business are actually in competition for management talent.

In government, management has been ignored as a class, and executives often have been appointed without adequate qualifications. The development of career men in the government is an approach to the recognition of the need for management, but that development has been woefully weak in the United States Government. Lack of recognition and monetary incentives, together with frustration accompany the government pattern of doing business, have driven valuable career men to leave the government and accept opportunities in private business or the professions.

The Civil Service system has the merit of reducing the extent to which all government employees are subject to appointment or removal for political considerations, but it has failed to provide incentives for the development of management. The system has provided one incentive that has not been adequately provided in business; that is, relative freedom from fear of insecurity of tenure. However, in general, people who have outstanding qualities for management do not place excessive value on this incentive, and those who do place great value on it usually lack other incentives to drive them to distinguished accomplishment. It is not intended to imply that the Civil Service system should be aimed exclusively at the class of people who have the qualities necessary for good management, but it is necessary to recognize that class of people who have the basic qualifications for management and to provide an atmosphere that will be favorable for their growth.

Good managers cannot be developed in any organization that has never known good managers. Good managers sow the seed for their own succession through giving incentives and opportunity and a desire for emulation on the part of promising individuals.

WHAT DOES "CONSISTENT" MEAN IN THE SHORT FORM REPORT?

DANIEL BORTH

All accountants' opinions accompanying some 150 currently published corporate financial statements (selected at random) were in short form. All included the standard or recommended phraseology which reads, in part, as follows: ". . . . in conformity with generally accepted accounting principles applied on a basis consistent in all material respects with that of the preceding year." None of the opinions included exceptions, qualifications, or explanations bearing *directly* upon the question of consistency with respect to generally accepted accounting principles.

The lack of exceptions, qualifications, or explanations concerning consistency is somewhat disturbing to the critical reader. In a period of rapidly changing economic conditions . . . from war to peace, from one phase of the business cycle to another, from one tax law to another, with changes in products, distribution methods, and administrative organization, with changes from a controlled economy to one of relative freedom, with labor unrest, inflation, and unsettled international economic conditions, it would seem that an audit would quite often result in some material differences of opinion (between the public accountant and management) on accounting principles which failed of reconciliation. Or, to put it another way, "are *accepted* principles of accounting so *consistently* applied by corporate management that the residual unresolved differences of opinion are almost invariably minor in character and not deserving of mention in the accountant's opinion?"

The following practices, as gleaned from management reports to stockholders in 1946 and early 1947 compared with reports of 1945 and early 1946, indicate that there is real reason for concern over the use of the term "consistent." In not one of the following cases (of which there are many quite similar) did management adequately explain or justify the changes in procedures and the underlying principles:

a. In one year "provision for contingencies" was charged against income; in the following a "provision for contingencies" was shown as a surplus charge.
b. In one year "Property Not in Use" was classified under "Property Plant and Equipment"; in the next this item was reported among the "Other Assets."
c. The basis for valuation of investments was "amortized cost" in one year; in the following the basis was changed to "cost or market, whichever is lower."
d. In one year a foreign subsidiary was included in the consolidated statements, but in the following year it was reported as an affiliated company. There was no stated change in the percentage of ownership and no obvious reasons for the change.
e. In the first year certain "non-recurring charges" were debited to earned surplus; but in the following year similar items appeared as income-determining charges.
f. Certain charges were made to capital surplus in one year. In the immediately preceding year, or two, no transaction-charges of similar nature were reported. But, in the last preceding year in which a similar transaction was reported, the charge was made against earned surplus.
g. In one year an intangible (goodwill, patents, etc.) was completely written off the books into surplus. In the previous year there was no amortization of the intangible or any stated policy on this subject. In the year of write-off no justification was given, even though the net income of the year of write-off showed an increase over the previous year.
h. In one year "sales discounts" were reported

as a deduction from sales; in the following, they were included in "Other Deductions."

i. In the latter year a "Reserve" section was employed, whereas in the previous years reserves were classified into appropriate categories and sections.

j. "Foreign exchange adjustments arising in consolidations" was credited to net income in one year, but in the following the same title was credited to surplus.

It must be admitted that the above practices only *seem* inconsistent. In the light of adequate explanations and justifications, the cited procedures might be adjudged consistent. But with no helfpul explanations the conclusion is easily drawn that the corporations are following inconsistent practices.

How is it that a published short-form report of the public accountant can almost invariably declare that generally accepted accounting principles are applied on a basis consistent with that of the preceding year? Is it because the differences in opinion on accounting "principles" are usually resolved, reconciled, or compromised prior to the preparation of the short-form report? Is it because the innovations in accounting principles and procedures are frequently the subject of comments and notes in the management's reports to stockholders? Or, is it because public accountants attach a technical meaning to the word "consistent" and to the phrase "generally accepted accounting principles"? The answer to all three questions is "Yes." The answer to the third question is a resounding "Yes."

The following interpretations of the two words and phrases indicate the "technical" meaning which is attached thereto. Following are excerpts from the report of the Committee on Auditing Procedures of the American Institute of Accountants:

> . . . An accounting principle may have only limited usage, but still have general acceptance, for example, the sinking-fund principle of depreciation.
>
> . . . While one concern may follow an accounting procedure distinctly peculiar to itself, this in no way disqualifies it being accorded a recognition of following "generally accepted accounting principles," if the broad principle which this procedure seeks to implement is, in fact, a generally accepted one.
>
> . . . It is important not to regard the matter of "generally accepted accounting principles" from a rigidity of viewpoint that could not possibly comport with the wide variety of operating conditions which will be encountered in business resulting in an equally wide variety of detailed accounting processes.[1]

And, with reference to the observance of consistency in the application of generally accepted principles, the Committee states, in part, as follows:

> Consistency of application of accounting principles should not be understood as denying a recognition of consistency where changes are made necessary by changes in operating conditions and other governing circumstances.[2]

This same committee quotes, with approval, SEC Rule 3.07 of Regulation S-X which emphasizes the importance of materiality and significance of effect of a change upon the question of consistency.

It should be apparent that the interpretation of "consistency" by the Committee on Auditing Standards is so broad that it has little significance in a document for public distribution. Just as in this election year, some are asking, "How broad is the middle of the road?," the question arises in this case whether the term "generally accepted accounting principles applied on a basis consistent" is not traveling a very broad middle of the road—in fact, so broad that the shoulders or fringes are barely discernible?

Assuming that the amounts involved in the above "cases" were material, who will say that the deviations in procedures are not significant to a careful interpretation of the corporate statements? Who will say

[1] Committee on Auditing Procedure, *Tentative Statement of Auditing Standards*, American Institute of Accountants, New York, 1937, pp. 39–40.

[2] *Ibid.*, p. 40.

that the practices cited are consistent in the light of inadequate explanations? Surely, if "consistent" has taken on such a technical meaning that all of the above "cases" represent consistent applications of generally accepted accounting principles, the time has come for a reconsideration of the meaning of key words in the short-form report.[3]

To be "consistent" with the preceding year, it should not be enough to say that the accounting principles of both the current and preceding year are *acceptable* and therefore the principles are *consistent.* Assuming materiality of the effect of changes, "consistent" as employed in the accountants' opinion should mean reasonable adherence to *the* accounting *principle* applied by the company to a specific item or class of items in the previous year.[4] If *seemingly similar* transactions in two successive years are handled under essentially distinct procedures because the transactions are *actually unlike,* there should be adequate disclosure. Responsibility also rests when essentially the same accounting procedure (i.e., arising out of the same accounting principle) is employed in the computation, recording, or presentation of two *basically different* transactions in successive periods. It is admitted that *an* accepted accounting principle is not a fixed but a relative concept. On the other hand, it is also true that *an* accepted principle is not inclusive of all accepted principles.

The inclusion of words of exception, qualification, and even explanation in the accountant's opinion tends to carry or imply some stigma of wrongdoing or deviation from the authority. How to attain adequate disclosure in the face of this reaction is a real question.

But, if the report of management to stockholders and employees (and other published reports carrying the "opinion" of the public accountant) fails to include explanations of apparent or seeming inconsistencies, the accountants opinion should give attention to this area of possible misunderstanding. To circumvent the stigma which conventionally attaches to a phrase or paragraph of exception in the "certificate," perhaps the opinion should be supported by paragraphs embracing such subjects as "Justifications for Changes in Certain Accounting Practices," "Trade Practices Influencing Accounting Procedures," etc. Reference in the accountant's opinion to pertinent sections of the report of management would be helpful.

The short-form report which might have its place and function as a part of an audit report to the client loses much if not all of its significance when taken out of context and included in the published report of management to stockholders and employees. If the accountant's opinion is to attain a position of real service and import in published corporate financial reports, it must be tailor-made by the public accountant to the needs of specific publications. To deserve careful and intelligent reading and understanding, individuality must be restored to the accountant's opinion. "Consistent," as presently employed, means little. "Consistent" must be restored to its usual denotation; it must adhere much closer to the center of the road.

[3] Charles B. Hellerson, "Short Form Auditor's Certificate is Obsolete; Revised Text Suggested," *Journal of Accountancy,* March, 1948, pp. 228–231.

[4] "Consistency, it will be observed, refers especially to uniformity in practice in two succeeding years, so that the results are truly comparable," Thomas H. Sanders, "Progress in Development of Basic Concepts," *Contemporary Accounting,* American Institute of Accountants, New York, 1945, p. 20.

THE LIMITATIONS OF CONSISTENCY

M. A. Binkley

Consistency in accounting usually is considered the policy of adhering to procedures which are identical with procedures used in the past. The definition gives little suggestion of the problems that might arise in an effort to follow the policy.

Most accountants would agree that the doctrine should be pursued with a limitation. It should be applied only is so far as there is no desirable need for a change of accounting procedure, for making such a change seems to violate the doctrine. It is this area that appears to deserve attention, since the limitation may at times be overlooked. Where consistency is wrongly applied, it becomes a fault rather than a virtue of accounting.

The major weakness of unlimited application of the doctrine is glaring when admitted errors are repeated. To omit an asset once from the balance sheet through error does not mean that future balance sheets should exclude the asset just because it would be consistent to do so. This idea seems well accepted and appears to call for a certain amount of inconsistency, thus providing an example of the limitation of the policy. If the doctrine does not apply in some cases and is felt to apply in others (as it must, judging from the many references to it in the literature), in what area does it apply? This is a concept that needs clarification lest application be made at the wrong places.

An example of improper application of consistency in accounting reasoning, it seems to the writer, occurred in the discussion about the propriety of restoring completely amortized but useful fixed assets to the accounts. The arguments against restoration included the claim that to restore the assets, and hence to take depreciation on them again, would be a violation of the doctrine of consistency. It was alleged that past statements would be inconsistent with current and future statements because the base for depreciation differed and the statements would not be comparable. At first glance it may appear that to restore the assets would be in violation of consistency and that one would have to choose between the doctrine and truthful reporting. It is here suggested that the doctrine of consistency is only intended to apply in accounting with limitation and it cannot apply without the limitation. To be consistently in error is to be consistent, to be sure, but it is in defeat of the ultimate goal of acounting: truth in reporting.

Probably the outstanding virtue of the doctrine is that it is an aid in providing comparable statements. A change of accounting procedures seems to put the statements of two time periods on a different basis and thus makes dependable comparison difficult. If an error of past accounting procedure is discovered, the question arises whether to make the correction, and hence produce supposedly incomparable statements, or to let the error ride and thus leave the statements on like bases. In such a situation at first it may be thought that there are only the two alternatives suggested, but there are really three. One alternative would be to make no correction and thus make for comparison. This would be comparison of erroneous statement with erroneous statement, which hardly appears to be a very dependable analysis. The second alternative would be to make the correction and thus provide a more reliable current report but one that could not be usefully compared with past statements. Since correction now would not "redeem the sins of the past," so to speak, this treatment leaves more to be desired.

The third alternative seems to be the

only satisfactory one. It is to correct the current and future statements and also to correct the past ones, or to give sufficient notice to the reader of the statements that he will be able to do the correcting for the past. This upholds the objective of truthfulness. If error was unavoidable in the past, the statements may have been the best attempts possible at the time, but if they can be made closer to the actual facts, accountants cannot with a clear conscience let bygones be bygones and ignore the imperfections of the past.

Now let us see which of the three alternatives presented above seems to fit into the realm of consistency advocated by the profession. The first alternative, the ignoring of the error of procedure, cannot be within the policy because it defeats the ultimate objective of truth. The second, the correction of only present and future statements, must not hold in accounting because it too is inadequate as far as truthfulness is concerned, for it neglects the past statements. The third alternative is here considered to uphold both consistency and truthfulness, since the past statements, when corrected, are then consistent with present and future statements, and they are the accountant's best effort at truthfulness.

It must be admitted that this proposal still includes a shortcoming. The major use of statements is current and the effect of current dependence on statements that later prove to be somewhat in error cannot, under present-day accounting, be remedied. It seems an example of unavoidable imperfection in the work of the profession. One suggestion, which however may not be considered adequate, is to educate the users of the statement in the idea that, although hindsight may prove the report to have been somewhat in error, it is simply the accountant's best effort at the time it is prepared.

A point that needs emphasis is that the accountant must continually adhere to a doctrine higher than that of consistency, since the latter is not in itself the major objective of accounting effort. The application of it as a policy should not preclude the attainment of the ultimate objectives. If consistency is at times in conflict with truth, the higher of the two must hold, and certainly truth is the higher.

In such a situation, the accountant is once again faced with evidence of a need for a crystallized set of accounting principles, organized into gradations. This would undoubtedly find truth placed high on the list, and consistency, if it appeared, would be lower.[1]

A set of principles of this type might contain the following in reference to our present consideration: Consistency is necessary for a fair comparison of reports, but is erroneously adhered to if it causes a neglect of truthfulness. In many cases truthfulness may be followed without great inconsistencies, as in the case of corrections of past statements.

As long as accountants feel that their statements are not infallible, that their work is not perfect, and as long as hindsight is more revealing than current judgment or foresight, errors will be discovered. This area of accounting which concerns the correction of past judgements is one under dispute, as evidenced by the distinct differences in opinions that have been disclosed. On the one hand some individuals believe in the permanency of past reports and of any decisions made at the time of their preparation, and on the other hand, some individuals believe that judgments, when appearing in error as the result of the advantage of hindsight, should be altered. The question is one of major significance, and it deserves further exploration.

Those upholding the permanency of statements suggest that if the decisions

[1] DR Scott expressed the same view in his article, "The Basis for Accounting Principles," in THE ACCOUNTING REVIEW of December, 1941, p. 344.

made in their preparation were arrived at in the normal manner and were certified, they should stand for all time. To alter them at a later date, it is alleged, is to admit their lack of integrity.[2]

Strong approval of this view was taken by Professor T. W. Leland in his recent discussion of the Revision of Statement of Principles. He distinguished between errors of judgment and errors of a mechanical nature, approving correction of the latter but not of the former.[3]

It appears to this writer that such a policy seems to challenge the very foundations of accounting. It seems to throw aside logic and exhalt conventionality or a rule of thumb. In short, it places consistency higher than realism.

To say that confidence in statements will decline if they are later corrected for errors is akin to saying that concealment of any errors or shortcomings will tend to promote confidence in statements. This seems to be the antithesis of desirable professional standards. The function of accounting is to disclose information concerning the enterprise, regardless of when the information is available. If more light can be thrown on the past at a later date than was possible currently, accountants have no right to withhold that light. To admit errors is to admit one's limitations, to be sure, but to admit no errors is to claim perfection that is unfounded.

In consideration of Mr. Leland's proposal of different treatment for mechanical errors as compared with errors in judgment, let us imagine a brief illustration. Assume that hindsight has revealed two errors of the past, both of identical amounts and both having identical effects upon the accounts. One is an error resulting from judgment and the other is the mechanical type of error. From the viewpoint of their distortion of the statements they are exactly the same. The cause of the error does not alter the effect of the error. Because the effect of each is undesirable, each should be eliminated to the extent possible.

The viewpoint that corrections have their place is strongly upheld by Professor Paton, who wrote:

> There is nothing sacred about past cost records and there is no reason to deny to accounting the possibility of revising recorded data when circumstances clearly indicate that the records are no longer reasonably in accord with the existing economic conditions. . . . If accounting is a matter of professional judgment, as opposed to rigid formula, we must certainly recognize the propriety of restatements, when more and better information becomes available.[4]

Such correction of errors is not a violation of the policy of consistency, but is simply an illustration of its limitations.

If the profession is to progress, it must be realized that more realistic reporting is at times effected by making improvements in accounting treatment. All improvements in a sense call for inconsistencies, for improvements are changes and changes make inconsistencies. So, on occasion, the accountant may have to decide whether to improve his work or to adhere to a narrow view of consistency.

It is not here advocated that consistency be completely overthrown. Not only is its application beneficial for comparison of reports, but it is helpful also in exerting a cautionary, steadying influence upon accountants. A change of major importance should be made advisedly, for there is a danger of lowering the quality and thus defeating the objective of improvement. The doctrine of consistency tends to prevent helter-skleter accounting. But this does not preclude changes that constitute improvement if the circumstances warrant.

[2] See the article by Eric L. Kohler in the round table debate on "Restoration of Fixed Asset Values to the Balance Sheet," THE ACCOUNTING REVIEW, April, 1947, p. 202.

[3] THE ACCOUNTING REVIEW, January, 1948, p. 20.

[4] W. A. Paton, "Accounting Policies and Management," *Bulletin of the Illinois Society of C.P.A.'s*, March, 1947, p. 14.

THE REQUIREMENTS AND OPPORTUNITIES IN INDUSTRY FOR STUDENTS OF ACCOUNTING

Fladger F. Tannery

Many signs lend encouraging promises to the future of the accounting student. In the past few decades the accountant has assumed and played a much greater and important part in the economic life of this country than in any previous period. And it seems that this may be just the beginning. As George O. May stated in an address entitled "Accounting as a Social Force":

> . . . a much wider area of development for the accountant is opening up than has ever existed in the past. . . . accounting must now be recognized as taking an essential place in law, government, business, and . . . economics. . . . Today is the era of the accountant, with all that this entails in the way of opportunity and responsibility.[1]

Business leaders are beginning to realize that it is just as important to have highly trained accounting technicians on their accounting staffs as it is to have lawyers on their legal staffs and engineers on their engineering staffs. These business leaders have learned through costly audits, system installations, federal tax assessments, and the like, that the old type "bookkeeper" (who knew little more than a debit from a credit) was, despite his low salary, a costly investment. They have found that their business will fail to prosper as it should unless their accountants can grow with it, assume new responsibilities, revise systems to meet operations, and help guide the business through the intricacies of modern government taxation and regulation.

In an article entitled "Current Problems of the Controller," Gay Carroll, Comptroller of Humble Oil & Refining Company, made the following statements:

> The theoretical aspects of business problems are important and must be clearly understood to stake out the boundaries within which practical solutions may properly be developed. Decisions, however, are invariably shaped by the practical considerations of the matter at hand, for only in this way can we give purpose and utility to our actions. . . . The application of sound accounting principles, the use of intelligent budgeting procedures, the development of cost systems, and the extension of auditing methods have played a major role in the administration of business during this same period. . . . Business stands today on the threshold of a new era. If its operations are to continue successfully and progressively, the difficulties and handicaps which now exist must be faced and solved. . . . If it is to exercise a beneficial influence in the future as it has in the past, patience, poise, good judgment, and sound decisions will be required. The basis of sound decisions, as always, will be rooted in intelligible analyses of business information—information which reflects results of the past and indicates the reasonable possibilities of the future. It is not difficult to place the controller in this picture. He must provide more significant operating and financial information, he must develop improved methods of analysis, and he must correlate the results of these with forces and conditions which influence future operating results.[2]

Seemingly unlimited opportunities are today within the grasp of the industrial accountant. His future depends entirely upon whether he is alert enough and courageous enough to capitalize on these opportunities. To do so, he must appreciate the meaning and importance of practical and effective management controls and strengthen these controls to assure maximum performance of the organization. Such measures are not merely theoretical

[1] *The Accountants Digest*, September 1944, p. 38.

[2] *The Controller*, April 1947, p. 190.

ideals; they can and must be determined.

During his university days the accounting student acquires the groundwork in accounting theory. If he is given a position in the business world in which he will use or observe the application of the specialized knowledge he gained in the classroom, he can apply his knowledge of theory to business problems.

The accounting student will have to decide which of the following principal fields of accounting he cares to enter:

1. Constructive accounting—the analysis, recording, interpretation, and reporting of business transactions
2. Internal auditing—appraisal of management and audit controls
3. Systems design—planning and research
4. Taxation and other problems of government regulation

Prior to an interview with his prospective employer, he will also have to decide whether he chooses to work for a small organization or a large one. There are advantages and disadvantages of both.

For the purpose of this paper, a small organization may be defined as one whose accounting department ranges in size from one to perhaps twenty-five employees. Usually the accountant or the accounting department receives and disburses all cash, prepares the pay roll and pays employees, records all income, allocates all expenditures to the proper income and expense accounts, and prepares the financial statements and tax returns. In such an organization there are about one, two, or three positions that are usually referred to as "good accounting jobs." There is no internal audit staff, tax department, or other separate department. The head of the accounting department is the internal auditor, the tax expert, the systems man, and so on.

There is no better place for the prospective accountant to try his "accounting wings" than in a small firm, particularly if it is growing. It gives him an opportunity to see what makes a business "tick." He encounters people engaged in all lines of endeavor and has an opportunity to broaden his accounting outlook. He sees the accounting picture in its entirety and the tie-in between functions, the "why" of accounting, how it affects the profits of the business, what it means to the owner, and how his work can be of most benefit. In addition, he has the personal satisfaction of being recognized in the community as the holder of an important and responsible position in his company. His salary may or may not be substantial, but he is recognized and respected as a member of the accounting profession.

The most important disadvantages of being an accountant for a small company are: (1) the limited number of so-called "good jobs"—usually one or two, (2) the limited range of business experience, restricted within the small company's sphere of activities, and (3) the comparatively low "job ceiling." A higher-salaried job usually requires the holder to direct the work of a large number of people and to make decisions which affect a great many people; therefore, the chances of working into the higher-salaried job do not always exist in a small firm.

In large organizations, such as major oil companies, steel companies, manufacturing concerns, railroads, public utilities, and insurance firms, the accounting department ranges from 100 to 1,000 employees. The accounting organization usually consists of both a line and a staff organization. Usually, but not always, the line organization performs only the constructive accounting, and the staff performs the specialties of internal auditing, systems research, and taxation. Depending upon the type and size of the company, the line organization is divided to parallel the company's operations—its plants, geographic areas, or major functions.

The disadvantages of a small concern are usually the advantages of a large one, and vice versa. In the large firm, probably a comparatively greater number of well paid accounting and other positions are open to the accountant; there is theoretically no job ceiling below the president; and there is a much broader field of business activity in which to acquire experience. At some levels of the organization, however, it may be difficult to see the purpose or appreciate the importance of the work. Some of the accountants may seldom see or know the men who actually run the business, and their mental outlook may tend to be confined to accounting matters. Unless the accountant is near the top in the accounting organization, he may not make many important decisions independently. Although his associates in the company know he has an important job, the public may think of him as another clerical employee of a large company. Community prestige is usually reserved for the few at the top of the organization.

Perhaps the accounting student's decision will be made easier if he can appreciate the scope and meaning of constructive accounting, internal auditing, systems research, and taxes, as well as the personal aptitudes and characteristics required for each.

CONSTRUCTIVE ACCOUNTING

Constructive accounting is the actual day-to-day analysis of business transactions, the recording of those transactions in the accounts, and the reporting and interpretation of the results of those transactions to operating and executive management. The work of an office engaged in constructive accounting might be organized along the following functional lines:

1. Cost Distribution or Coding Section—This section would receive all documents that form the basis of accounting entries, such as invoices charging the company for material or services, and would analyze the charges to the proper expense or capital account.
2. Accounts Payable Section—This section would preaudit invoices and prepare them for payment after determining that they are properly approved and supported.
3. Billing Section—This section would prepare the company invoices charging others for material or services rendered.
4. Accounts Receivable Section—This section would see that payment is received from customers for the invoices prepared by the Billing Section. It would mail statements to customers and keep the detailed records of their accounts with the company.
5. Inventory Section—This section would keep detailed records of the company's inventories that are of sufficient size and value to warrant the expense.
6. Property, Plant and Equipment Section—This section would keep detailed records of the cost of all tangible property of the company that is used in the operation of the business.
7. General Ledger Section—This section would combine the daily or monthly results of the work of each of the other sections and prepare financial statements and various operating reports for management.

Many accounting graduates feel that there is more prestige and more opportunity for advancement as an internal auditor, a systems man, or a tax expert, than as a constructive accountant. This is not necessarily true, particularly if the company has a progressive policy of personnel administration. There is no better place for the accountant to prepare for an administrative accounting position than in the constructive accounting office. There he can see at first hand the complex problems that are caused by mere volume. He is closely associated with the people he some day hopes to supervise. Their thinking, their problems, their pleasures, and their complaints become real to him. He knows how it feels to have an understanding boss or an unreasonable one, and he knows how it feels to have thousands of pieces of paper pass over his desk with no

end in sight. This gives him training and experience he can acquire in no other place, and it is invaluable to the good administrator.

There is also the satisfaction of doing a job in which he can observe results that are of tangible value to the company. As he progresses, he can improve antiquated procedures, eliminate useless work, and utilize all personnel at maximum efficiency. True, these are also the responsibilities of the systems and procedures group, but that group does not have day-to-day opportunities to observe all of the chances for improvement. Finally, there is a great deal of pleasure to be gained from the preparation of useful financial statements or operating reports. A good accountant who thinks in terms of "what does management want and need?" can easily become the right-hand man of the operating executive. He develops a sense of belonging to the organization and feels that his efforts are furthering the success of the company.

The accountant best suited for this type of work is one who likes people and enjoys working as part of a group—one who is capable of being not only a good leader but also a good follower. He should enjoy working with figures and should not be easily frustrated by great volumes of work and a mass of details. Those who have participated extensively in extracurricular activities while in school might make the best constructive accountants because of their interest in people and in outside activities.

INTERNAL AUDITING

Internal auditing is the field of industrial accounting that most closely parallels the practice of public accounting. Basically, both are attempting to establish the reliability of financial reports, to determine the adequacy of internal control, and to promote the consistent use of accepted accounting principles. Their objectives are similar, but their functions are distinctly different. The internal auditor is responsible to the management for an objective appraisal of the activities of the business. The public accountant, on the other hand, must express to the stockholders, employees, banks, and the public at large, a professional opinion that is completely independent of the influence of management.

It is true that in many large companies today the internal audit staff performs no more than a "check and double-check" function. The responsibility of the group is limited to determining that proper entries are being made on the books of account, and that the system of internal control is adequate to prevent fraud or the misappropriation of funds. In the more progressive companies, a new philosophy of internal auditing has been developed which is sometimes referred to as "managerial auditing." With the advent of machine methods of bookkeeping and the mechanical perfection of many internal controls, the checking of internal work, for the sake of verification only, has, under the managerial auditing philosophy, become almost a waste of time. However, if in the performance of his verification work, the internal auditor adopts an "inquiring approach," and asks "who—what—how—and why" as he examines the policies, procedures, practices, and employee day-to-day work habits, he will obtain the information needed to appraise the results of operations, as well as the manner in which these operations are carried out. It should be mentioned, in this connection, that an enthusiastic interest in the company's operations, and a knowledge thereof, are highly important to the success of the internal auditor.

The opportunities that exist in the internal auditing field are self-evident. The internal auditor is given an opportunity to study the accounts and the accounting

methods used by every department of the company. He is delegated by some upper level of management to appraise the work procedures of these departments to see that they are being performed properly and in accordance with management's directions. Because of this, contacts with management are much more frequent than in the case of the average accounting employee, and such contacts can be highly opportune to advancement. He should develop enough knowledge of the accounting procedures of each department so that he would be able to hold a supervisory accounting position in the event such an opening presents itself.

A good internal auditor must be loyal, honest, and sincere, and have a pleasing personality. He must have an aptitude for most business subjects and a constant desire for further self-development. And, of course, he should be able to work with both supervisors and assistants cooperatively toward a common goal.

SYSTEMS AND PROCEDURES

The field of systems and procedures is more technical than the two just described. The young accountant should probably not accept a position in a systems and procedures group until he has had several years' experience in either constructive accounting, internal auditing, or public accounting. However, he should at least know the functions of such a group and know something of the opportunities it offers.

The broad purpose of having a systems and procedures division in the accounting organization is to improve the effectiveness of accounting results and the efficiency of methods by which they are obtained. To accomplish this purpose, the staff must perform the following specific functions:

1. Critically analyze, appraise, and test the application of accounting principles always with the view of determining the efficacy of the principles employed in light of changing operations
2. Improve the data provided management for control of operations
3. Reduce the time required to place information in the hands of management or to produce other end-results of accounting
4. Develop the greatest utilization of mechanical equipment for performance of mass repetitive-type clerical functions
5. Eliminate duplicating, overlapping, or unnecessary functions
6. Evaluate location and assignment of clerical functions in relation to efficient operations, and determine that functions are logically grouped and properly supervised
7. Speed the flow of paper work from one unit to another
8. Improve the form and content of all records and reports
9. Analyze clerical routines such as sorting, filing, posting, to assure efficient performance
10. Conduct research on special problems

The opportunities afforded an industrial accountant in this field are almost identical with those enumerated for the internal auditor. Those who desire to enter this type of work, however, should possess certain native abilities that have not previously been mentioned in connection with the constructive accountant or the internal auditor. A good systems and procedures man is very much like a research chemist. He studies the way certain functions are being performed or certain principles are applied, and attempts to develop a better method of performance. He must be a man who has the scientific approach—that is, if the results of his work indicate that improvements cannot be made, he is just as satisfied as if he had proved that there was ample room for improvement. Nonproductive work does not strike him as being wasted effort. More than in any other field, imagination and creative ability are of primary importance. Good systems and procedures men are scarce, and the field is wide open to the aspiring accountant.

TAXES

In the field of taxation, the emphasis is on federal income taxes. Here again is a specialized field in which it is difficult to evaluate the opportunities for men starting out in the accounting profession. As in the case of systems and procedures work, some actual experience in constructive accounting is highly desirable before an attempt is made to specialize in taxes. As those who have had a course in tax accounting know, our tax laws are highly complex and are constantly being changed as the prosperity of the nation rises and falls and the political parties gain and lose power.

In addition to a thorough familiarity with all of the tax regulations pertaining to the business of his company, a good tax man must possess an almost intimate knowledge of the company's operations.

In no field is it more important that the accountant know in advance each operating change, in order to anticipate its tax significance. He must study the court decisions that are being handed down daily to see if any of them affect the company's business practice, and must be able to advise management of propitious times, taxwise, to sell certain holdings or to develop income-producing properties. The accounting graduate who desires to enter the tax field should have a definite aptitude for matters of a legal nature and a liking for constant reading of the tax services that are used by most present-day businesses. Tax savings can be effected through a proper tax handling of business transactions, and the value of the tax accountant in this connection is easily discernible to the management of the company.

Through these four fields of accounting it is possible to reach, ultimately, the level of an executive or policy-making accountant. Naturally, the accounting graduate cannot start at the top, but there is certain groundwork that he must begin to lay if he is to reach that level.

First, there is the basic accounting or technical training. Every successful accountant must have a sound and thorough knowledge of the principles of accounting and the techniques of their application. Accounting theory, however, is comparable in some respects to the rules of grammar and literary composition. A writer learns the rules, but only after much practice and experience does he really know how to use them in writing effectively. In the practice of accounting, rules and principles are guides—not laws, and not substitutes for ability and sound practical judgment. To be successful, the accounting student will have to develop a resourcefulness for a common-sense application of rules and theory. He should not neglect general academic education, nor limit himself to accounting alone. A strong background of grammar and composition will prove invaluable throughout his business career. He should absorb all of the so-called "culture subjects" that he can, and if possible, take some elementary or appreciation courses in economics, engineering, chemistry, or physics so he will have an appreciation of those professions. In other words, he should attempt to broaden his outlook as much as he can.

The mastery of technical requirements alone will not assure development into business executives unless equal attention is given to certain important personal characteristics. Outstanding leaders are not necessarily the best students, the best athletes, or the best looking individuals. But these leaders do have an intangible "something" that makes them stand out from the crowd. This intangible "something" is not always a natural gift; often it is developed by the individual who is able to achieve a balance between his technical and his personal qualifications. Fortunately, everyone can develop quali-

ties in their personalities that will assist them in becoming better administrators and supervisors. In almost any successful business executive, there is a full and even development of six specific characteristics. These six personal qualities are: thoroughness, fairness, initiative, tact, enthusiasm, and emotional control.

Thoroughness. Thoroughness is probably the most essential factor in developing sound decisions, for it is this quality that enables an individual to obtain all the facts that are pertinent to a problem at hand. Most erroneous decisions or solutions to problems are probably not due to lack of knowledge or ability. On the contrary, it is likely that these are caused by a lack of thoroughness in obtaining all the facts, or in overlooking some small but essential detail. Perhaps a good way to form this important habit of thoroughness is to ask three simple questions before any job is finished:

1. Have I been thorough?
2. Have I obtained all the information I need?
3. Have I taken care of every necessary detail?

Fairness. One should never lose sight of the fact that employees are human beings —not machines—and that they work more willingly if they feel that their supervisors deal fairly with them in all matters. If one overlooks this important aspect of human relations, there is no better way to invite grievances from his associates and subordinates. In developing this trait, there is no better standard than the Golden Rule, for if one will take the trouble to consider each problem from the viewpoint of his subordinates and form his conclusions accordingly, he will more apt to gain the confidence of his employees.

Initiative. Initiative is the capacity for assuming responsibility and for starting and doing things, and the ability to carry through an undertaking without requiring too much detailed supervision. It is that spark that prompts an individual to begin a necessary job without being told to do it, and involves the exercise of courage, self-confidence, decisiveness, and resourcefulness. In most cases, the development of initiative is simply the conquering of fear which arises from a lack of self-confidence in individual ability. If we analyze the causes of this deficiency, we will usually find that it arises from a lack of knowledge, experience, responsibility, or imagination. The approach to the development of initiative, then, is to increase our knowledge of our job; to learn the refinements of its operations through experience; to endeavor to arrive at sound conclusions; to analyze these decisions in the light of subsequent developments as a means of applying this knowledge to future problems; and to give answers and decisions, then later weigh or evaluate the results objectively.

Tact. Tact is the faculty to work courteously, considerately, and sensibly with superiors, subordinates, and associates to obtain desired results and maintain their confidence, loyalty, and good will. Particularly in a large organization where the coordination and cooperation of a great number of individuals is an inherent requirement to the successful functioning of any activity, tact becomes doubly important. The exercise of diplomacy will not only assist in getting the job done, but it will also generate that cordial support of associates which is necessary in the advancement of every individual.

Enthusiasm. Enthusiasm may be defined as an intense and eager interest in, and a devotion to, a cause, a pursuit, or an ideal. An individual who possesses enthusiasm for his job is one who is not easily overcome by difficulties and whose interest will not permit him to give up before obtaining a practical solution. To be most effective, enthusiasm should be of the caliber that will arouse the interest and best efforts of others and that will

encourage them to exert their entire energies to the problem at hand. Enthusiasm cannot be generated in groups of individuals unless there is a genuine interest on the part of a leader who has the knowledge, ability, and patience to direct the efforts of others toward the achievement of established objectives.

Emotional Control. Strong business executives will almost always have strong emotions, as evidenced by a high ambition and fierce pride in their own abilities. Indeed, it is these qualities that probably motivate them in all their activities. The problem, then, is not to eliminate emotions but to control and channel them so as to obtain positive rather than negative results. In the face of difficulties and disappointments, we should teach ourselves to restrain our emotions in a manner that will prevent us from doing or saying anything that will jeopardize the loyalty, confidence, and support given us by others.

These remarks have outlined some of the requirements of an executive accountant and have given the personal characteristics that are required. The degree of success attained will be in direct proportion to the ability to develop and balance these qualities.

In closing this paper, it may be said that the growing importance of accounting in modern business is clearly evident. There was a long period when accounting was held in low regard and was considered a necessary evil because its processes required nothing more than record keeping. Even today some top businessmen do not fully understand the assistance that accountants are equipped to give them through intelligent—yes, even scientific—analyses of financial data. It is an encouraging fact, however, that in dealing with the ever-increasing complexity of business problems today executives are depending to a greater extent than ever before on accounting as a means of controlling activities to achieve objectives. America's dynamic economic system, the increasing demands of governmental and labor organizations, and the extensive growth of industrial concerns involving rapid technological improvements, wide geographical dispersions of properties and activities have all had their part in recent years in complicating business problems. This situation establishes a challenge to this relatively young profession of accounting to develop accounting processes that are geared to operations and that are capable of producing data and analyses to assist management. To meet this challenge the profession must pull into its ranks people with a broader background of education, people with a greater amount of thoroughness, more desire to be fair, greater initiative, unlimited amount of tact, abounding enthusiasm, great emotional control, personality, and business courage. With the help of these new recruits, the "regulars" of the profession will be better able to shake off the shackles of many of the formalities of accounting that tend to make it stereotyped and unrealistic and that often prevent its practical application to business problems. The reward for those willing to devote themselves to the job of becoming accounting executives is indicated by a quotation from a report that presented the results of a survey of business executives conducted by *Fortune* magazine: "As for the fact that 94 per cent of the executives like their present positions, *Fortune* concludes that 100 per cent of those polled are well-paid 'successes' and that the successful are proverbially happy."

ACCOUNTING ASPECTS OF PROTECTIVE PROVISIONS IN INDUSTRIAL PREFERRED STOCKS

JOSEPH F. BRADLEY

ACCOUNTANTS COME in contact with protective provisions in industrial preferred stocks on three occasions, namely: (1) the accountant has to record certain aspects of these protective provisions such as the recording of retirement fund transactions, (2) the accountant, as an auditor, may have to verify certain transactions as being in accord with protective provisions as stated in the charter, and (3) the accountant may be called upon as a consultant to give his opinion on such matters as the amount of adjustment required in conversion prices in cases where the corporation engages in acts which dilute the conversion right. The three protective provisions selected for analysis are retirement funds, restrictions on paying dividends to common stockholders, and conversion rights. This study is based on 250 industrial preferred stock issues registered with the Securities and Exchange Commission during the period 1944–1946. The information was obtained from parts of registration statements filed with the Commission by the issuers.

Preferred stock retirement funds are of interest to accountants on two main scores, namely: (1) the recording aspects of retirement fund transactions require that the accountant be familiar with the charter provisions pertaining to the retirement fund, and (2) auditing duties often require that accountants verify the sums set aside as being in agreement with the provisions in the charter for the establishment of the fund. That a careful analysis of charter provisions pertaining to retirement funds is often necessary is attested to by the fact that of the 250 industrial preferred issues examined, 157 issues (63 per cent) contained provisions for the establishment of a retirement fund for preferred stock. The following sections deal with the more important aspects of retirement funds from the accountant's viewpoint.

In this study the methods of determining the annual contribution to the fund were found to be classifiable into three groups, namely: (1) plans based primarily on the amount of profit earned in the preceding year, (2) plans based on the retirement of a per cent of the number of preferred shares issued, and (3) other plans.

Plan (1) provides that the annual installment to the retirement fund be based primarily on the preceding year's profit. Often a per cent of the preceding year's profit, after subtracting preferred stock dividend requirements, is set aside for the fund. Of the 250 industrial preferred issues reviewed, 157 issues contained retirement funds and of this number, 77 issues (49 per cent of the 157 issues) based the annual contribution to the retirement fund primarily on the preceding year's net income available to common stockholders. The General Builders Supply Corporation 5 per cent cumulative convertible preferred stock provides that within 120 days after the close of each fiscal year the company is required to set aside as a retirement fund for the preferred stock a sum equal to $12\frac{1}{2}$ per cent of the consolidated earnings of the previous year which were available to common stockholders. Certified public accountants must verify

both the net income and the amount set aside for the retirement fund.

Plan (2) provides that the sum to be set aside must be sufficient to retire a per cent of the preferred shares issued. This plan will result in the gradual retirement of the preferred shares but it may take a long time since the requirement occurring most often was that which necessitated the setting aside a sum of cash sufficient to redeem only two per cent of the greatest number of preferred shares issued. Fifty-nine issues (38 per cent of the 157 issues with retirement funds) contained provisions which called for the setting aside of a sum of cash each year which would be sufficient to retire a small per cent of the preferred shares issued. The Universal Pictures Company, Inc. $4\frac{1}{4}$ per cent cumulative preferred stock requires that each year a sum of cash be set aside for the retirement of two per cent of the largest number of preferred shares at any time theretofore issued.

Plan (3) includes miscellaneous provisions for the determination of the annual contribution to the retirement fund. Of the 157 industrial preferred issues with retirement funds, 21 issues (13 per cent) based the annual contribution to the retirement fund on these miscellaneous bases. The A. S. Campbell preferred stock provides an example of this kind of provision. The company is required to set aside annually a sum of cash sufficient to retire three per cent of the largest number of shares of preferred stock at any time theretofore outstanding together with a sum equal to five per cent of the consolidated net earnings available to common stockholders for the preceding year. Miscellaneous plans are often a combination of plans (1) and (2).

After funds have been set aside for the retirement of preferred stock we may further classify the funds on the basis of the certainty that the money in the funds will be used to retire preferred stock. In terms of this classification three kinds of funds were found to exist. The first group will be referred to as "sinking funds." The second group will be referred to as "purchase funds" and the third group will be referred to as "combination purchase and sinking funds." It should be noted that the charters in many instances used the generic term "sinking fund" to cover all classifications just mentioned.

Under the "sinking fund" plan, once the money is put in the fund it must be expended for the retirement of preferred stock. This is the usual type of retirement fund. Of the 157 industrial preferred issues with retirement funds, 139 issues (89 per cent) used the sinking fund plan.

Under the second classification, that of "purchase funds," the money in the fund need be expanded for the retirement of preferred stock only if the shares can be purchased at or below designated prices. If the preferred shares can not be acquired at or below these prices within a limited period of time, the money in the purchase fund usually reverts to the company and may be used for general corporate purposes. The corporation's obligation to retire preferred shares for that period is then cancelled. The term purchase fund is used here to describe this type of operation because the program of retirement is based on the expectation that the preferred share may be purchased at or below designated prices. The Elliott Company 5 per cent cumulative preferred stock provides an example of the use of the purchase fund. The Elliott Company is required to set aside on each May 1 and November 1 a sum equal to four per cent of the previous year's consolidated earnings available to common stockholders. Each purchase fund may be used by the company to purchase preferred stock in the open market at prices below the redemption price. The company must accept offers received by it

to sell stock at or below the redemption price for a fifteen-day period immediately preceding the next purchase fund installment date to the extent of the money available for such purchases. Any money remaining in the fund as a result of the inability of the corporation to buy preferred stock at or below the redemption price reverts to the general funds of the company and may be used for general corporate purposes. Of the 157 industrial preferred issues with retirement funds, only 13 issues (8 per cent) contained the purchase fund.

Some of the industrial preferred shares contained a combination of the "purchase fund" and the "sinking fund." When this arrangement exists it is customary to have the purchase fund in operation for a specified number of years—such as five or ten—and then to switch over to the sinking fund. The Murray corporation of America cumulative preferred stock contains a combination of the purchase fund and the sinking fund in that a purchase fund is to be in operation from 1945 to 1955; after 1955 the retirement program is to be based on the sinking fund arrangement. Only five of the 157 issues contained this type of retirement fund provision.

RESTRICTIONS ON PAYING DIVIDENDS ON COMMON SHARES

Public accountants have an interest in these restrictions because as part of their auditing duties they may have to verify transactions involving the payment of dividends on common shares. The accountant must look to the charter for guidance on this point. A few of these restrictions on paying dividends on common shares as long as there is preferred stock outstanding will now be considered.

First, there is the restriction on paying dividends to the holders of common shares when payments to preferred stock retirement funds are in arrears. For example, Trailmobile Company $4\frac{1}{4}$ per cent cumulative preferred stock provides that as long as there is any default in the retirement fund, the directors can not declare dividends on the common stock. However, the charter may permit the payment of dividends on common shares even though preferred stock retirement fund installments are overdue provided the preferred stockholders give their consent to this transaction.

Another type of restriction on removing assets from the business as long as there is preferred stock outstanding is that which prohibits dividend payments on common shares when certain financial tests do not meet standards prescribed in the charter. These financial standards are superimposed on the usual legal requirements that there be surplus available before dividends can be paid on common stock and that there be no accumulated dividends on the preferred stock when dividends are paid on the common stock.

One type of restriction on paying dividends on common stock as long as there is preferred stock outstanding is that which requires the surplus to be in excess of a predetermined amount before the directors can declare dividends on common stock. A wide variety of practices were used as methods of limiting the amount of dividends that common stockholders could receive when the surplus was below a minimum amount. First, there is the situation where there is a given amount of earned surplus at the time the preferred stock is issued. The charter may "freeze" this surplus and thus prevent its decrease through dividend payments on common shares. An example of this type of provision is to be found in the Armstrong Rubber Company $4\frac{3}{4}$ per cent cumulative convertible preferred stock which requires that dividends on common be paid only out of earnings accruing to the corporation after September 30, 1944.

A second type of restriction on the payment of dividends to common stockholders as long as there is preferred stock outstanding is that which requires the surplus to be several times the quarterly dividend requirements on the preferred stock before dividends may be paid on the common. The Doyle Manufacturing Corporation 60 cents convertible preferred stock prohibits the payment of dividends on common shares if, after the payment, the earned surplus would be less than an amount equal to the sum of eight quarterly dividends on the outstanding preferred stock. Another illustration of this type of restriction may be found in the Colgate-Palmolive-Peet Company \$3.50 preferred stock. This issue prohibits the payment of dividends on common shares without the consent of the holders of a majority of the preferred shares if after the dividend payment on the common the surplus would be less than the dividend requirements for a three-year period on the outstanding preferred stock.

In addition to passing a surplus test before common shares may receive dividends, the corporation may also have to pass certain liquidity tests before directors may declare dividends on common shares. For example, the Thomas Steel Company $4\frac{1}{4}$ per cent cumulative preferred stock provides that among other restrictions on paying dividends to the common, the net current assets after dividend payment on the common must be at least two-thirds of the par of the outstanding preferred. Another issue, that of the General Motors Corporation \$3.75 series, prohibits the payment of dividends on the common unless after the payment the net quick assets are greater than the current liabilities by \$75.00 for each share of preferred stock outstanding.

Other charter-stated financial tests may have to be passed before the directors can declare dividends on the common stock. The Allis-Chalmers Manufacturing Company $3\frac{1}{4}$ per cent cumulative convertible preferred stock provides that no dividends may be paid on the common shares if after the payment the consolidated net tangible assets would be less than twice the sum of the consolidated funded debt and the involuntary liquidation value of the outstanding preferred stock. Yet another type of restriction on paying dividends on common shares was found in the Victor Chemical Works $3\frac{1}{2}$ per cent cumulative preferred stock. This issue prohibits the payment of dividends on common stock if the aggregate dividends paid on common stock plus any amount expended in purchasing common stock exceeds the sum of (1) surplus earned subsequent to October 31, 1945, (2) the net proceeds to the company resulting from the sale of junior securities after October 31, 1945, and (3) \$500,000. This is a commonly used type of provision in industrial preferred stocks.

CONVERSION RIGHTS

Convertible preferred stock means that the issuing corporation will exchange other securities for the preferred shares at the option of the preferred stockholders under conditions stated in the charter. Of the 250 industrial preferred issues analyzed 116 issues (46 per cent) were convertible. The accountant's concern with conversion is two-fold: first, the change in the composition of the capital structure as a result of the exercising of the conversion privilege involves the recording function; and second, the accountant may be called upon as a disinterested party to give his opinion on the amount of change needed in the conversion price if the corporation engages in any act which would dilute the conversion privilege of the preferred stockholders. For example, the Johns-Manville Corporation $3\frac{1}{2}$ per cent cumulative preferred stock provides that if conversion

rights are diluted by any action on the part of the corporation, the board of directors shall appoint independent public accountants to render an opinion on the amount of change necessary in the conversion price to offset any dilution which might have been caused by these acts on the part of the board of directors. Upon receipt of such opinion the board of directors is required to make the adjustments recommended by the accountants. A similar provision is to be found in the Carrier Corporation $4\frac{1}{2}$ per cent preferred stock. This issue provides that if the corporation engages in certain acts which lead to dilution, the board of directors shall appoint a firm of independent public accountants who shall give their opinion as to the amount of change, if any, in the conversion prices required to offset any dilution in the conversion right. A few of the main aspects of conversion of interest to accountants, will be treated briefly at this point.

Preferred stockholders need protection against the dilution or destruction of their conversion rights because in the absence of such protective provisions the corporation is under no obligation to preserve the value of the conversion right. Examples of corporate acts which would dilute or even destroy the conversion right are, (1) the issuance of shares of common stock (other than shares issued upon conversion of the preferred stock) for a consideration less than the conversion price then in effect, (2) the granting of rights to buy common stock for a price less than the conversion price, (3) the payment of stock dividends, (4) a stock split, and (5) a merger, consolidation, or sale of all the assets. Corporate charters do not always prohibit acts on the part of the corporation which would dilute the conversion rights of the preferred stockholders; instead, the conversion price of the common stock may be changed so that the relative position of the preferred stockholders does not change.

An important protection usually offered holders of preferred shares is that which requires certain adjustments in the event that common stock is issued below the prevailing conversion price. These adjustments change the conversion prices so that the privilege to convert is not diluted. Stock splits and stock dividends are included in the practices which are deemed to result in the issue of common stock for less than the conversion price of the common stock. Suppose, for example, that holders of fifty dollar par value preferred stock are entitled to one share of common stock upon conversion. As the market price of the common stock approached fifty dollars the corporation might double the number of shares of common stock outstanding through a stock split or a stock dividend. This might cut the market value of the common stock approximately in half. A preferred stockholder would then have to wait until the market price of the common returned to around fifty dollars before he could make a profit on the conversion. To protect the preferred stockholders under these assumptions the accountant might recommend that the conversion rate be changed to two shares of common for each share of converted preferred stock.

Charters often require that the dilution be a certain amount before accountants will be called on to recommend an adjustment in the conversion price. If, for example, an action of the corporation diluted the preferred stock conversion right by one-half of one cent, it is not likely that the corporation would be required to change the conversion price to take into consideration this small amount of dilution. The Textron Incorporated 5 per cent convertible preferred stock provides that no adjustments in the conversion price shall be made unless the change amounts to fifty cents or more. The Standard Oil Company of Ohio $4\frac{1}{4}$ per cent cumulative

preferred stock provides that no adjustment in the conversion price is to be made unless the conversion price then in effect is changed by twenty-five cents or more.

The charter may require that all converted preferred stock be cancelled and not again reissued. The Standard Oil Company of Ohio $4\frac{1}{4}$ per cent preferred stock requires that all shares of preferred stock converted be cancelled and not reissued.

When the privilege of conversion is exercised, the number of shares which a preferred stockholder is entitled to does not always represent a whole number but instead may come out, for example, to $3\frac{1}{4}$ shares of common stock. Corporations instead of issuing fractional shares issue "script certificates," which, when combined with a sufficient number of other script certificates, entitle the holder to a share of common stock. These script certificates are usually non-voting, non-dividend bearing, bearing in form, and limited in life. The Miller-Wohl Company Inc. 5 per cent cumulative preferred stock contains a series of provisions pertaining to the conversion rights of the preferred stockholders. One of these provisions states that the corporation is not required upon conversion to issue fractional shares of common stock but may issue in lieu thereof non-dividend bearing and non-voting script certificates, each representing a fractional right to receive a share of stock. The General Tire and Rubber Company $3\frac{3}{4}$ per cent convertible second preferred stock also contains provisions for the issue of script certificates. Under the terms of this issue, no fractional shares of common stock may be issued upon conversion but in lieu thereof, non-voting, non-dividend-bearing script certificates are to be issued. Script certificates in amounts aggregating one or more shares may be exchanged for stock certificates at any time on or before December 31, in the third calendar year after the date of the issuance of the script certificates. After this date the company will either sell for the account of the holders of outstanding script certificates the number of full shares represented thereby, or will deposit with a transfer agent the market price of the equivalent in full shares, and thereafter at any time within the next three years the holders of script certificates may receive their pro rata share of the cash set aside. After the expiration of this second three-year period the script certificates become void. In accounting for these script certificates, as in the case of other protective provisions, the accountant must look to the charter for guidance in order to discharge effectively his duties as consultant, auditor, and recorder.

INVENTORY RESERVES; WHY AND WHEN

HERBERT D. SOPER

THIS IS AN inflationary period, a period of abnormality and of unusual implications. This is a period of spiraling prices that many have never experienced before and one that requires going back 30 years to find a counterpart. There has developed in this present period an unreality in many things, including financial reporting. One of the most significant areas in which this unreality is centered is in monetary inventory valuations and profits. From this condition and the need of a means to deal with it has come the subject of inventory reserves, particularly reserves for future inventory price declines, a subject widely discussed and likewise controversial. Inasmuch as this inflationary period is an abnormal upheaval of the economic structure, the application and serviceability of traditional accounting concepts must be examined in light of present-day needs. It is with this background that the subject of inventory reserves; why and when, particularly reserves for future price declines, must be considered.

Before passing on to this particular phase of inventory reserves consideration should be given to the application of inventory reserves to two other areas; namely, (1) valuation reserves, and (2) reserves for replacement of inventories involuntarily liquidated applicable to inventories priced on the basis of last-in, first-out.

Valuation reserves are provided to cover the adjustment of inventory pricing to the lower of cost or market, adjustments that may be necessitated by physical deterioration, obsolescence, or price change. Generally, however, the use of such reserves for pricing purposes is not widespread inasmuch as valuation adjustments are usually made as reductions applied directly to the inventory amounts. While there are situations where the use of inventory reserves of this nature is preferable, say reserves to reduce to market inventories priced under the last-in, first-out or "lifo" method, the practical difficulties that may surround its application for income tax purposes and the ease by which direct inventory write-downs can be made limit its practical application in most cases.

The reserve for replacement of inventories involuntarily liquidated has its application to inventories priced under the "lifo" method. In substance, this reserve recognizes the necessity, in the interest of a fair presentation of income, of charging operations in the year of liquidation with an amount estimated to be the excess of replacement cost over the cost of the abnormally low priced inventory involuntarily liquidated. Although this type of reserve is new and generally limited in application, it is soundly conceived and meets the underlying accounting principle of matching current costs against current revenues. This is true even though at the time the reserve provision is made it must be made on an estimated basis as to future replacement cost. It is better to make a fully considered estimate in the light of all available facts than to set up no reserve at all. Also, a retroactive tax deduction to the year of liquidation is available under the Internal Revenue Code in the proper circumstances and when the involuntarily liquidated inventory carried on a "lifo" tax basis is subsequently replaced.

Inventory reserves of greatest import at the present time relate to those for future

price declines. In October, 1947, the Committee on Accounting Procedures of the American Institute of Accountants, in its Accounting Research Bulletin Number 31 on the subject of Inventory Reserves, stated that in their opinion inventory reserves, such as those created,

(a) for possible future inventory loss on inventories not on hand or contracted for, or
(b) without regard to any specific loss reasonably related to the operations of the current period, or
(c) for the purpose of reducing inventories other than to a basis which is in accordance with generally accepted accounting principles

are of such a nature that charges or credits relating to such reserve should not enter into the determination of net income and that they should not be used to relieve the income account of any year.

The Securities and Exchange Commission in actual practice has also taken this same position and their Chief Accountant, Mr. Earle C. King, at the University of Michigan in November 1947, after referring to numerous press reports concerning the unreal and fictitious nature of profits realized from the disposition of low cost inventories which are replaced at higher prices, stated:

> Conceding the economic point that is being made, I dissent from the implication of deliberately false representation that is conveyed by the use of the term "fictitious." The economic concept has not been developed and reduced to such a satisfactory basis for accounting measurement as would warrant the abandonment of the cost basis.

He goes on to say that management must consider the influence of changing price levels in many activities including the determination of a dividend policy. He recognizes that, if reserves for future price declines will assist in convincing stockholders and other interested parties that profits must be retained in the business, "directors are justified in creating such reserves—but not as a factor in determining net income."

There is probably no better summary of my views on this subject at this point than that of Mr. Paul K. Knight when he dissented from the conclusion of American Institute's Committee on Accounting Procedures, of which he is a member, as follows:

> Traditional accounting practices are clearly inadequate to cope with existing extraordinary price inflation and subsequent substantial deflation that appears inevitable based on past experience. Obviously reserve provisions made capriciously to equalize profits between years must be condemned. It seems equally plain, however, that accounting rules should not force business to report inventory profits as unqualifiedly realized in the face of conviction that such profits will never be realized. Neither should business be forced to adopt the involved last-in, first-out method as the only means of eliminating such profits. This extraordinary price situation requires sensible tolerance in making objective tests of business judgments exercised in good faith and realistic consideration of substance rather than technical adherence to form.

Now what is this extraordinary price inflation? This is most readily dealt with by reference to the U. S. Department of Labor, Bureau of Labor Statistics, index of wholesale prices with 1926 as the base year, from which it can be seen that over a period of many years there have been four very high price peaks and four very severe price declines, and that there is now in the making a fifth very high peak. These statistics are summarized as follows:

Period	*Approximate Peak*	*Approximate Decline*
Revolutionary War	180	To 70
War of 1812	160	To 60
Civil War	130	To 50
World War I	160	To 60
World War II	160 (At present)	?

Events of such unusual and far reaching significance that occur only once in a generation require the application of not the usual methods and techniques, but the

application of sound principles that will clearly portray the reality of the situation. To illustrate, if an individual sells a block of General Motors stock for $100,000, such amount being $25,000 in excess of his cost, and immediately invests that same $100,000 on a voluntary basis in another block of General Motors stock, would one insist (except for income tax purposes) that such individual had made a profit of $25,000? Or, suppose that an individual sold a home that cost him $10,000 for $15,000 and then immediately purchased for $15,000 a house comparable in all respects to the one he sold, would one say that individual had realized a $5,000 profit? In monetary terms, yes. But in reality—that is, having tangible cash to use elsewhere—no. Is there any difference between this and the paper manufacturer who paid twenty dollars a cord for pulpwood only to find several months later, after profitably selling this pulpwood in the form of paper, that to keep his mill running he must now pay twenty-five dollars a cord? Conventional accounting would say that the additional five dollars required to be invested in inventories is profit. But is that company in any better position than before? Does that company have a greater quantity of pulpwood, does it have command over profit funds for plant expansion, debt retirement or dividend payments?

It is not, however, the investment of profit dollars in inventories that is unrealistic. The crux of this whole problem is in the ultimate loss inherent in a normal inventory acquired in an inflationary period, a period of instability such as this. Mention is made of normal inventory because reserves of this type have no application to inventories held for speculative purposes or covered by hedging transactions. In most situations a normal inventory quantity must at all times be maintained in order to stay in business on an efficient and profitable basis. Under conditions of spiraling prices there is in each purchase, as well as in each purchase commitment, an inherent loss of some future period. Take for example the steel jobber who over a period of many years, in order to operate efficiently and to serve his customers, has had to carry an inventory of one million pounds of steel at all times. This jobber knows, through years of experience, that when the cost of his steel goes up the effect is immediately felt in his steel inventory which he then sells at an increased price. Conversely, this jobber knows that when the cost of his steel goes down the effect is again immediately felt in his steel inventory which he must sell at a reduced price. It is with this knowledge that the steel jobber views with skepticism a two dollar per ton price increase in today's inflationary market. True, he will make a handsome profit in monetary terms with respect to the million pounds of steel inventory. But from experience he knows that in some future period when the price is reduced in like amount, he will immediately suffer an offsetting reduction in such profit. Accordingly, he views the profits realized from inventory price increases as transitory in nature eventually to be offset by inventory price reductions.

It is the recognition of this loss inherent in the situation of extraordinarily high prices that gives rise to unrealistic profits. This situation accountingwise can be met not by the application of something new but by the adherence to two old and basic accounting concepts, accounting principles in fact. The one is to "provide for all losses and anticipate no profits" and the other is to "match current costs against current revenue." Reserves for future inventory price declines are merely an application of these old principles, the recording of a loss in the face of overwhelming conviction that a loss is inevitable and

should be measured, and the matching of inflated costs against inflated profits.

One writer in the *Journal of Accountancy* recently condemned inventory reserves on the premise that extraordinary profits and losses should be recorded in the year of final occurrence so that the operating results could be measured against the economic backdrop of the times. But what is the economic backdrop of this period? Spoken in the terms of traditional monetary profits, this is a most prosperous time. But, economically speaking, with the matching of economic costs—costs in goods and services—against economic revenue, it may be that our prosperity is a little overdone. Much is currently being written on the subject of fictitious profits and the ignoring of economic costs. In order to report adequately in monetary terms that which is happening economically, mustn't current economic costs be matched against current revenue? Actually does a loss occur in the period of price decline or does it not really have its genesis in the rising market? Isn't that where the loss inherent in the future is born? Accountants are searching for facts and, accordingly, should be certain that business facts are recorded in their true economic light.

Opponents of inventory reserves frequently ask "how can it be accurately measured?" and refer to such provisions as "speculative guesses." By so asking they in effect give sanction to the principle but deny its application because of their fear of its possible misuse and belief that it is better to make no correction at all than to make one premised on estimates. Actually, there have been cases where reserve provisions have been misused to misstate profits rather than to provide for losses. But the possibility of misuse should not be the controlling factor in deciding whether inventory reserves are right or wrong in principle. It should merely challenge accountants to further proper application and to condemn inventory reserves based on whims, or designed to manipulate profits. Inventory reserves can be provided on a basis that is sound, a matter of computation based on a sound formula that measures substantially the estimated future loss inherent in the inventory by reason of price inflation. A reserve so determined is auditable, can be controlled, and is not subject to capricious application. If such reasoning of opponents had prevailed in the past, accountants would never have anticipated investment losses, for example, in cases where the ultimate amount of realization was undeterminable. Or, no attempt would ever have been made to adopt depreciation accounting or to recognize obsolescence in the accounts. Accounting is full of judgment factors and accountants should apply their best thought to the determination of future inventory losses inherent in today's situation in the light of the price behavior patterns of the past.

There is precedent for inventory costs determined under both the first-in, first-out method and the last-in, first-out method. Although the two methods are diametrically opposed in theory, and have vastly different results in periods of changing prices, both are generally accepted accounting methods. Now why, or how, can proponents of "fifo" or "lifo" extoll those two methods as right, in either extreme, and condemn the use of the inventory reserve method that may be close to either or some place in between? In other words, "either fifo or lifo is right but inventory reserves are wrong." Actually the "lifo" method is merely a limited application of the inventory reserve method. It, in substance, ties itself to a base price and from that point on matches current costs against current revenue and provides for future losses inherent in the inventory in a period of rising prices. A company,

however, should not be compelled to adopt the involved and rigid "lifo" method, together with its income tax implications, as the only means of dealing with this problem. Inventory reserves are provided for estimated future losses, losses measured not in their entirety by strict adherence to a rigidly fixed base price of the past but by objectively applying the experience of the past with reasoned judgment as to the future. It is better objectively to approach such a situation through the means of an inventory reserve than to be compelled to follow either a technical "fifo" or "lifo" form in the face of a compelling conviction that something else is right. Further, few companies on the "lifo" basis disclose the effect of that method of pricing on the income statement or balance sheet, while the reserve method, with full disclosure, clearly sets out the effect of its use and furnishes much pertinent information. Actually a number of companies have set up inventory reserves based substantially on the "lifo" principle in an amount equivalent to the increase in prices. Such reserve provisions have been passed by the Securities and Exchange Commission and it is possible that the Committee on Accounting Procedures of the American Institute of Accountants would not be unduly critical.

At this point it is undoubtedly clear that the reserve provision for future inventory losses is not a deduction for income tax purposes, the Internal Revenue Code generally allowing such losses only at the time that all related events in connection therewith have occurred. Accordingly, in determining the amount of the inventory reserve provision, the related income tax effect must be taken into consideration.

Because of the nature of this type of reserve full disclosure of its amount and use should be made. In this manner the reader may clearly see the import of current conditions and have a full understanding of the accounting procedures followed to reflect its implication. This may best be done in the income statement by showing the charge for the reserve provision as the last deduction before net income. Preference for this position arises from the fact that the provision is stated after recognizing the income tax effect and because the effect of the provision on net income is clearly set out. With clear disclosure, it is also quite proper to show the provision as a part of cost of sales. In the balance sheet the preferable location of this reserve is to show it on the liability side so that the immediate and long-run implications thereof in analyses of financial position can be readily measured. Another location used in certain instances is as a deduction from the total of the inventories separately set out on the asset side.

There is, in general, nothing unusual about the subsequent use of this reserve after once provided. Until the inevitable economic adjustment has occurred, this reserve should continue to be carried in the financial reporting of a company. When, however, the adjustment does occur, the losses consummated at that time, net of the related income tax effect, should be charged to this reserve, either directly or by crediting the applicable portion thereof as the last item on the income statement before net profit, equivalent to the losses included elsewhere therein. In either event, full disclosure should be made in the reporting of the loss and of the treatment in the financial statements. After the economic adjustment has occurred in its entirety, any unused balance of the reserve should be returned directly to earned surplus if material in amount.

If accountants are to keep pace, to develop their profession, they must continue to search for new applications of sound principles and at times disregard conventional applications of normal times. No

real advance was ever made in any field of endeavor by closing one's eyes and mind to change and the need for special application of old principles in new and unusually different situations.

The precedent and authoritative support for such inventory reserves does exist, although its application to present conditions is not as readily understood because of the infrequency of the conditions requiring its use and the fear of its misuse. But the problem is here, and it must be met in a realistic way. Inventory reserves are right in principle, old principles applied in face of extraordinary and unusual conditions. If it is right in principle, it is a sound tool of financial reporting.

COMPARISON BETWEEN GOVERNMENTAL AND GENERAL ACCOUNTING

LEO HERBERT

ACCOUNTING FOR GOVERNMENTAL and institutional bodies is a means to an end and is not the end by itself. Recent criticism of the field of governmental accounting has resulted because, as so often happens in commercial accounting, heads of accounting departments think that as a result of the control vested in them, their department is the final governing body. One authority states that he believes governmental administration "does not require the use of involved accounting systems, procedures, or techniques; except in occasional, special situations."[1]

The realm of governmental accounting involves a system of accounting rather than the development of a new branch of record-keeping. It has the same procedures and theories of debits and credits which are found in general accounting. However, since conditions of governments and institutions differ from those found in manufacturing and selling, needs of governmental systems diverge from those found in general accounting. These needs include new terminology and new assumptions not ordinarily found in general accounting.

In addition, rules and regulations of the governing body must be followed in every case. Governmental accounting methods are often guided by regulations rather than by strict accounting theory. Nevertheless, governmental accounting is becoming more important to the accounting profession as time passes. In the *Reports to the Council of the American Institute of Accountants* for May, 1947, the Committee on Governmental Accounting states:

> It is the conclusion of this committee that governmental accounting offers a relatively undeveloped field in which the accounting profession has an opportunity to render substantially increased services to governmental agencies and institutions on a basis which will add materially to the prestige of the profession and will represent a worthwhile contribution to better government.[2]

In order to show comparisons between governmental and general accounting, the following basic concepts are developed:

1. Funds
2. Profits
3. Control
4. Managerial Usage of Accounting Data

FUNDS

Funds of a governmental body may be compared to numerous corporations all of whose stock is owned by a single individual. The corporations are all separate accounting entities and legally or economically are not related. They do not render consolidated reports even though owned and controlled by one individual because not one of them owns or controls any part of the other. Likewise, each fund in governmental accounting is a separate accounting entity. Each is separate and distinct from all other funds although controlled by legislative and executive authority which controls all funds. A governmental body demands that monies pertaining to different funds be accounted for separately, and even though the unit controls all of the different functions, each separate fund is not controlled by any other fund.

Ordinarily, a governmental unit is broken down into the following classifica-

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[1] T. Coleman Andrews, "Accounting and the Management of Public Affairs," THE ACCOUNTING REVIEW, October, 1947, pp. 367–371.

[2] *Reports to Council*, American Institute of Accountants, New York, N.Y., May, 1947, p. 10.

tions for accounting and administrative purposes:

1. General Government (General Fund)
2. Special Categories (Special Revenue Fund)
3. Bond Receipts and Disbursements (Bond Fund)
4. Gathering of Funds for Bond Payments (Bond Sinking Fund)
5. Holding or Gathering of Funds for Others (Trust and Agency Fund)
6. Part Interest Relationships (Special Assessment Funds)
7. Service Organizations (Working Capital Fund)
8. Utility Operations (Utility Fund)
9. Recording of Long-Term Assets and Liabilities (Fixed Asset and Bonded Debt Group of Accounts)

Accounting for some of the above classifications is similar to that found in general accounting or in some other particular type of accounting system. For example, accounting for a utility fund in a governmental unit is similar to accounting for a private utility; accounting for trust and agency funds provides the same accounting records found in an estate or trust accounting system.

The funds which demand different accounting concepts from those which are found in general accounting are:

1. The General and Special Revenue Funds
2. The Bond Fund
3. The Bond Sinking Fund
4. The Special Assessments Fund
5. The Fixed Asset and Bonded Debt Records

The purpose of a general fund is to account for the receipts and disbursements of all monies pertaining to the general operation of a governmental unit.

A special revenue fund is employed to account for any specific allocation of revenues not found in a general fund.

In a bond fund is recorded information pertaining to the receipts and disbursements of money received from the sales of bonds. Separate funds are usually operated for each separate sale of bonds.

A bond sinking fund accounts for all sums collected for the final retirement of bonds.

A special assessments fund is employed to record the receipts and disbursements for improvements, the benefit of which goes to someone in addition to the governmental unit. Since the governmental unit has only a part interest, all receipts and disbursements are accounted for which pertain to property holders, the governmental organization, the construction project, bonds, and notes.

Since only receipts and disbursements are considered in practically all of the above categories, no record of fixed assets and fixed liabilities would be kept unless a separate group of accounts was provided for that purpose.

Thus, it may be stated, that for accounting purposes, a fund is an independent accounting entity with a self-balancing group of accounts.

PROFITS

General accounting is concerned with profit-making. Profits have been defined as being the excess of revenues over costs in a given transaction or series of transactions. Revenues, of necessity, are specifically related to the costs to determine net profit.

Governmental accounting, in the funds not specifically related to general accounting, pertains to record-keeping of the governmental unit's receipts and disbursements.

Revenues in governmental and general accounting have somewhat different interpretations. In governmental accounting, revenues mean proprietorship available for expenditure acquired from increases in net assets, other than recoveries of other expenditures. In general accounting, revenues mean the proceeds from sale or services. A gift of cash, therefore, would be revenue to a governmental agency while it would not to a commercial enterprise; an

expenditure for building would be expended revenue in a governmental organization, but would not be deducted directly from revenue in general accounting.

In general accounting it is necessary to account for all costs and to allocate those costs to revenues for a particular period to determine net income. In governmental accounting the records kept are those of revenues and expenditures, and furthermore, the cost of a building, a bridge, or equipment is just as much an expenditure as the cost of labor or supplies. Generally speaking, the revenues are allocated to expenditures in governmental accounting rather than applying costs to revenues which is found in general accounting. Profit-making ordinarily is no concern of a governmental administrator, and almost all theory regarding accounting for profits is excluded from a governmental accounting system.

CONTROL

In commercial accounting usually there has to be a cost outlay before revenues are secured. A direct relationship exists between costs and revenues.

In governmental accounting there cannot be an outlay for costs before the revenue has been determined. Seldom does one find any direct bearing on the revenues of a governmental unit as a result of the expenditures of that unit. In fact, the reverse is generally true, no authorization for expenditure can be made until adequate revenues have been determined available.

Internal control can be secured in a profit enterprise by having one individual check on another's work. In addition to the above method, control in a governmental unit can be secured by controlling the expenditures of the unit, so that expenditures do not exceed receipts. Control of expenditures in a governmental unit is accomplished by allocating certain appropriations to each budgetary unit, thus allotting each unit a maximum of expenditures. Controlling the expenditures of a governmental unit seldom has any effect on the revenues of the governmental organization.

In commercial accounting very little progress has been made in budgeting, since the exact control of expenses has a definite effect on the revenues of the concern. An attempt has been made to secure budgetary control in general accounting through the use of flexible budgets that vary expenses with the amount of income secured.

Often there is confusion in the mind of a person who for the first time sees the accounts of a governmental unit. New accounts are necessary to record information pertaining to budgetary analysis and seldom, if ever, are any of the accounts found in general accounting. Estimated Revenues, Appropriations, Allotments, and Encumbrances are terms that are exclusively in the vocabulary of a governmental accountant.

MANAGERIAL USAGE OF ACCOUNTING DATA

Undoubtedly it is true that the general field of accounting is much further ahead in the managerial usage of accounting data than is the governmental field. Governmental managers have attempted to let the budgetary appropriations of the unit be the sole managerial guide to efficiency. What, therefore, has happened is that the total aim of the governmental manager is to have his appropriation increased, no matter how much service is rendered by the department or how efficiently the service is rendered. Managers of profit-making businesses derive benefits from the fact that expenses are definitely related to the income secured. If the expenses are out of line with the income, which can readily be determined by cost accounting and through departmentalization, then the

department head has some explaining to do. Governmental expenditures usually are considered with regard to appropriations which may be too high or too low. Usually all departmental appropriations are increased or decreased in somewhat of a similar percentage. The result is that the department which has already built up the largest appropriation continues to receive the greatest amount, regardless of the amount of service being rendered.

Eventually some form of comparison between expenditures and services rendered will have to be secured. In all governmental units which include some form of profit-making this can now be done through the use of cost accounting and better internal control. In other funds comparisons with other similar units operated elsewhere can possibly be employed successfully.

CONCLUSION

In conclusion it may be said that governmental and general accounting systems employ the same basic double entry concepts. The individuality of funds found in a governmental accounting system is somewhat different from the single business concept of general accounting.

Profits, as a general rule, play no important part in the functions of a governmental unit. Revenues and expenditures do.

Control in a governmental accounting system at present is founded mainly on budgetary appropriations. Since the appropriations are no measure of the success of services rendered by the budgetary unit, a possibility exists that some method of correlating services rendered with appropriations eventually will be secured. This has been accomplished in general accounting by comparison of revenues with costs to determine whether the enterprise is profitable. Currently, comparison of costs of services rendered in a governmental unit with revenue or appropriations is limited to certain specific funds.

STAFF TRAINING—PRESENT AND FUTURE[1]

ALVIN R. JENNINGS

PUBLIC ACCOUNTING is a personal-service profession. Its future depends to a large degree upon its ability to continue to attract the highest quality of recruits and in increasing numbers. Improvement of academic standards and improvement in selection of personnel are tremendously important fundamentals.

Formalized staff training which has evolved from the experimental to the development stage is the medium through which our profession can discharge its obligation to bridge the gap between theory and practice. The contribution of staff training to a well integrated personnel policy is so manifest as to leave little if indeed any scope for serious debate. The form in which training may best be accomplished and the area in which it may be applied most productively remain questions in which the profession has a searching interest.

I seriously doubt whether there is any one answer to these questions. What might be appropriate and fitting in one firm might by reason of circumstances be entirely impracticable in another. Even within the same firm where offices are widely separated geographically it may be necessary to adopt differing approaches particularly if the size of staff at the several offices varies. It has been suggested that you might be interested in the staff training program which we follow in our firm. For that purpose I shall outline the program which we have in effect in our New York office although for the reasons which I have just given the same approach is not used in all of our offices.

We believe that we have accomplished a great deal in staff training. We are equally convinced that there are many things (particularly in the field of formalized training at advanced staff levels) which we should be doing and which we ultimately hope to accomplish but which are not presently being done in the way in which we think they should be done. As I proceed I shall try to make clear the distinction between present practices and future potentialities.

TRAINING THE BEGINNER

Despite the excellent curricula in accounting and related subjects which have been developed by the colleges and universities the student, even the accounting major having a fine scholastic record is not ready immediately to participate in audit engagements. A period of intensive indoctrination is essential. Our recognition of this need led us to inaugurate a formal student-training program some twenty years ago. Except during the period of the war and during certain of the depression years when very few students were employed we have annually conducted such a course. During that period we have had students from 52 colleges and universities and we are rather proud of the fact that notwithstanding the break in continuity brought about by the war 54 per cent of the men who started in these classes are still with the firm.

As might be expected in the early days of our experience we were rather feeling our way along. The course was conducted under the guidance of one of our staff supervisors who had had some teaching

[1] This paper was presented at the annual meeting of the American Accounting Association in New York in September, 1947.

experience. The method of instruction consisted primarily of lectures, the basic purpose of which was to provide auditing instruction which in many schools at that time either was not included in the curricula or was dealt with only casually.

In time it became apparent that staff training was a matter of sufficient scope and importance to justify consideration on its own merits rather than as a by-product of employment. At the termination of the war we were fortunate in securing the services of a young man who had first come to us as a student in 1933 and who after seven years on the staff had been requisitioned by the American Institute of Accountants to serve as research assistant on its staff where he remained until he accepted a commission in the United States Naval Reserve, from which he subsequently was transferred to the Office of Contract Settlement to act as research associate in accounting. His background, which also included lecturing at several universities, in our judgment ideally equipped him to direct our training program.

The reinstitution last Summer of our training school for students afforded an opportunity to reappraise the entire project.

PROGRAM

Classes were held five days a week from 9:00 A.M. to 4:30 P.M. and from 9:00 to 12:30 on Saturdays over an eight-week period. While no night work was prescribed by the instructor most of the students indicated that they had done considerable work on their own time. A program was designed which included the following features:

Audit practice case
Lectures
Talks by students
CPA examinations
Mathematical problems
Use of reference material
Business machines

The students were also given a list of collateral reading material with which they were expected to become familiar, including copies of the bulletins issued by the Committee on Practice of our firm.

While no rigid daily program was adhered to, nearly every day some consideration was given to each of the above matters—except for business machines which consumed only three afternoons. A typical day would start with a lecture by a member of the New York Staff followed by supplementary comments by the instructor. After a brief intermission, the balance of the morning would be available for work by the student on the practice set, CPA problems or reference reading. On some days however no time would be available for such study and research.

Immediately after lunch one of the students would make a ten-minute talk to the class, which would be followed by questions and discussion on the subject matter. Next, the class would work one of the addition or other mathematical problems, and the day would be completed with the instructor's discussion of a section of the practice set or part of the CPA examinations. The schedule was purposely made flexible in order to permit adequate consideration of each point at the time it was being considered, to the extent the daily program permitted.

Audit Practice Case. The audit practice case was the foundation for the course. Despite certain limitations, such as the practicality of some of the case material, one of the recognized published audit practice sets was used for the practice case. These sets involved the making of a balance-sheet audit on the basis of assumed facts, and the preparation of a long-form report on the examination. The work material included a complete set of books of account; specimen documents; information as to the accounting procedures and internal control of the client; instructions

to the student; and, in some cases, copies of specimen working papers and audit report for the prior year. Each phase of the practice set was discussed by the instructor and amplified by technical lectures by staff members.

Lectures. The lectures by supervisors and experienced seniors comprised formal presentations of the subject matter, illustrated with examples from actual practice and reference to actual working papers and reports, followed by an informal discussion period. Starting with a general lecture on a subject such as the administration of an audit, the presentations covered: inquiry into internal control, audit programs, working papers, reports, audit procedures applicable to the various phases of an audit, income taxes, cost accounting, relations with clients, and audit problems of special types of engagements, such as banks, non-profit institutions, public utilities, investment companies, retail establishments, and mining companies. Whenever practicable, and to the extent applicable, these lectures were given at the time the subject matter was being considered in the practice set.

Lectures and discussions on conduct of staff members are particularly important. They should emphasize the importance of personal appearance, respect for confidential information of clients, and the proper approach to professional work. Of importance equal to technical auditing ability is the ability to deal with clients tactfully and maintain their respect and confidence. We try to impress upon the students that differences of opinion may be expected to arise in practice and that the accountant should be able to present his case carefully, objectively, and convincingly. While it may not be possible to train staff men in the important technique of getting along with people in business, sound advice and emphasis on its importance is of assistance.

Participation of Partners. We consider it desirable to have partners appear before the class and discuss various matters of a professional nature, such as public accounting as a career, professional ethics, historical background of the firm, accounting societies and their work, and the work of partners. In addition to providing the students with a wealth of valuable information, these lectures enable the students to meet the partners on a more or less informal basis.

Training in Expression. Without intending to assign any responsibility for the condition, I must, in frankness, report to you that we have consistently found students to be lacking in ability to express themselves effectively, orally or in writing. These are attributes which are of universal importance. They are of considerable consequence to one who seeks a successful career in public accounting. An engagement may be completed with more than ordinary technical skill yet the client gains a totally different impression if the auditor's report is poorly drafted.

In the limited time available in the training class all we can hope to accomplish is to instill an understanding of the importance of the problem and the need for later concentrated application to its solution.

During the course, we do require each student to prepare and present to the class a short talk on an assigned subject in auditing procedure. At the conclusion of each talk, the student answers questions and leads a discussion on the subject matter. Criticisms are then made by the instructor and the class on the quality of the material and the presentation. These talks give the student experience in technical research, writing, and speaking before a group, and afford an opportunity for constructive criticism of shortcomings. Further attention to this subject must await advanced training which I shall touch upon later.

COMPOSITION OF 1946 CLASS

Our most recently completed training school (1946) was attended by 36 staff men In many respects the class was unique. Because of the special personnel situation created by the war not all of its members were students in the normal sense. The men were considerably older than would be the case in more normal years. Ages ranged from 21 to 34 years with an average of almost 27 years. Of the 36 men in the class, 32 were former service men and 27 were college graduates. Most of the nongraduates had arranged to take evening courses in colleges or schools of accountancy to make up necessary credits. Again, the business backgrounds of the students were quite diversified. Most of the men (29) had had some public accounting experience, ranging from a few months to two years, but averaging less than a year. Four of the men had had other business experience only, and 3 men had no previous experience of any kind. Several of the men had been in business other than public accounting for several years, one having had 10 years of such experience as well as one year of public accounting.

For the reasons given, it was necessary to direct the various activities at a level which would be most beneficial to the group as a whole—not too elementary for the more experienced men, and not too complicated for the inexperienced. While the diversity of experience and backgrounds tended to enrich the course, more homogeneous groups probably will comprise future schools and consequently simplify the curriculum.

STUDENTS' COMMENTS ON SCHOOL

We believed the students could furnish helpful suggestions for consideration in future schools. Accordingly, toward the completion of the course each student was asked to appraise the twelve major aspects of the course and to make any additional comments and suggestions on the course as a whole. The following information was sought as to each phase of the course: (a) rating of each item in relation to the other items of the course; (b) opinion on the value of each item, whether good, fair or poor; and (c) opinion on the time devoted to each item, whether excessive, adequate or insufficient.

The replies indicated that the five most important parts of the course, in order of importance, were: audit practice case, instructor's lectures, lectures by members of the staff, students' talks, and the use of *Contemporary Accounting* as required reading. All but two of the phases of the course were rated predominately as good; mathematical problems other than addition, and the consideration of business machines were rated predominately as fair.

The tabulation of the results also indicated generally that insufficient time may have been devoted to the audit practice case, *Contemporary Accounting*, CPA examinations, and mathematical problems other than addition. There also seemed to be a general feeling that more time should have been devoted to study in class, most students indicating that they were required to perform part of the work at home. In contrast, a few of the more aggressive students suggested that even more work should be required to be performed on the students' own time.

While these ratings and comments by the students should aid in planning future schools, the replies in many cases undoubtedly were influenced by the backgrounds of the individuals. Those students who had worked audit practice cases in colleges, or who had had more public accounting experience than the others, naturally gave less weight to the audit practice case. Others who were naturally proficient in addition or familiar with the solution of

other mathematical problems gave less weight to those items. On the whole, however, the replies indicated that the students were very enthusiastic about the course and had benefited through their participation. Several of the students made enthusiastic comments to that effect in their questionnaires.

The replies of the students, among other things, disclosed a highly developed sense of diplomacy. To a man they accorded the highest rating to the instructor's lectures! Perhaps in a precocious display of the quality of independence so important to the independent public accountant, three of the class appraised the lectures by partners as only "fair."

POST-SCHOOL FOLLOWUP

A very important part of our personnel policy, applicable to all staff members up to the rank of staff supervisor, is the personnel report which is required to be submitted by a staff member's superior promptly upon the release of the staff member from the assignment which the report covers. It is through the medium of these reports that our personnel manager and the partner in charge of personnel are enabled to keep informed currently on the progress of staff men. At about the time when we were planning the reinstitution of our training school in 1946 we thought that it would be a good idea to develop a particular type of personnel report to be submitted in respect of students during the first year of their employment. The report which was devised seemed to be so much better than the one which we had in use for other staff members that we decided to apply it universally. I shall not take time now to describe the report to you in detail. A copy of the report appears at the end of this paper so that you may, if interested, review the characteristics and qualities which we feel provide an index to progress.

REFRESHER SESSION

Another important aspect of our follow-up on students who have been in the training school is a "refresher" session which is held late in the spring after we have had an opportunity to see what the students have accomplished in the field during the months which elapsed following the termination of the formal training classes. The purpose of this refresher session is to review the work performed by the men during the winter, to point out the specific faults which had been observed, to bring the men up to date on recent developments, and to afford the men an opportunity to discuss any questions which had arisen during their assignments and which remained unanswered. Preparatory to holding this session a special review was made of the personnel reports of the training school men and a special letter was sent to each of the staff supervisors and seniors asking them to submit any general criticisms or comments which would be helpful to the purposes of the review. A large part of the refresher session was devoted to a discussion of the faults reflected by the personnel reports and replies received to the special letter sent to supervisors and seniors. While these replies covered a wide range of activities the preponderance of the comments indicated a need for more instruction in the preparation and filing of working papers as well as a decided tendency on the part of junior members of the staff to abstract ledger accounts instead of making summary analyses supplemented by examination of the accounting evidence supporting the transactions reflected in the summaries. Other faults noted were the failure to indicate in the working papers what audit steps had been taken, and lack of an adequate cross reference to related accounts. In one or two instances criticism was made of the junior's informal conduct on examinations and excessive familiarity with the client.

These faults and criticisms were discussed with the group without identification of the individuals who occasioned the criticisms. Later, in individual interviews where the fault was considered to warrant such action, further discussion was had with the delinquent individual. Since, as noted, the most frequent criticism was addressed to the need for improving working-paper technique, special emphasis was placed upon this subject during the session and specimen working papers covering a wide variety of situations were distributed by the instructor for discussion and to aid in illustrating the essential requirements of the preparation of working papers.

All in all, I would say that we were rather pleased with the results accomplished by the first training school in the post-war period. As I believe previous comments have indicated, we have learned much from the observations made by the students. Particularly, I believe there is a need for getting the program a little more down to earth in the sense of laying greater stress on fundamentals, arranging for fewer lectures by supervisors and more by seniors and others with whom the student will be in closer association in field work, etc.

ADVANCED TRAINING

It is not enough that beginners be properly indoctrinated; training must be continued in some form throughout the public accountant's career. Change is the natural companion of progress and public accountancy will go forward only to the degree that it is able to match strides with the requirements of business demands. Staff men and partners alike must keep in constant touch with new developments affecting the profession.

Participation in Work of Professional Societies. In a suitable occupational environment, the enthusiasm and ambition of youth, under proper guidance, are incentives which may be depended upon to keep the beginner working for his certificate. As soon as a man has become qualified by obtaining his certificate we urge that he join a state society and the American Institute of Accountants as well as any other professional associations which are of particular interest to those who may choose to specialize in certain fields such as, for example, cost accounting or tax practice. By actively working on the committees of these societies, staff men obtain an intimate understanding of the problems peculiar to various fields of accounting and are afforded an opportunity of enlarging their acquaintanceship with others in the profession.

On-The-Job Training. The "apprenticeship" method of instruction for many years was the traditional and, more often than not, the sole training method employed by the profession. In recent years so much emphasis has been placed upon more formalized methods of training that it would be easy for a tendency to develop to subordinate, if not to ignore, the apprenticeship approach. This, I believe, would be a sad mistake for I regard the potentialities of that field to be far greater than is generally realized. Other forms of training at advanced staff levels should be looked upon as collateral to on-the-job instruction rather than as substitutes.

Maturity of judgment and acuteness of perception come from experience gained in working under competent supervision. There is something about personal participation in the solution of a problem on the scene and at the time when it arises which crystallizes and makes the lesson gained indelible.

The objective we are seeking involves an increasingly greater dependence upon instruction on the job by men at high levels. As you well know, it does not necessarily follow that because a man is a good tech-

nician he will also be a good instructor. This is the principal obstacle to deriving maximum benefits from field instruction. In time a greater proportion of total staff at top levels will be constituted of men who have been through the whole cycle of training and who, accordingly, should have a correspondingly increased appreciation of their responsibility to instruct assistants.

The advantages of rotation of staff on engagements are obvious. Much may be accomplished to provide opportunities for well rounded experience through this medium.

Staff Meetings. There is considerable question in my mind as to the practicability and benefits to be derived from regularly scheduled classes for staff members at levels higher than that of beginners. In the first place there is bound to be a substantial conflict between the demands of assignments on the available time of individuals and the demands of regularly scheduled classes. Secondly, I feel that over the course of time a program of regularly scheduled classes deteriorates in quality through a tendency to consider the holding of the class as of greater importance than the exchange of ideas which should be the paramount consideration.

Staff meetings held to discuss particular subjects, as a need becomes apparent, are profitable. As research bulletins are issued by the Committee on Accounting Procedure and the Committee on Auditing Procedure of the American Institute it has proven helpful to hold staff meetings and to have someone who is familiar with the development of the subject in the Committee explain the background and be available for answering questions as to its application in practice. We believe that this concentrated form of discussion of a particular subject results in fixing the matter in the minds of the men so that when a problem arises in practice they will recall the existence of the applicable bulletin.

Another method which we have used to some extent, and will probably use to greater extent in the future, is to appoint committees of staff men to investigate and report upon special subjects as, for example, the very interesting and important matter of the relation between the existing degree of internal control and the appropriate scope of audit. By including a few carefully selected seniors in the committees which are constituted preponderantly of staff supervisors, some assurance of the continuity of approach is gained in that the seniors, by service on the committees, obtain experience which will be helpful to them after they have become supervisors. The results of the studies of these committees may be transmitted to the staff either through staff bulletins or at special meetings. If it is believed that the determinations of the committee are most appropriately transmitted to the staff through meetings, it becomes a function of the committee to arrange for a series of meetings. One of the problems which faces an organization with a large staff is the inability adequately to deal with a subject in large groups. The meetings, which are in the nature of clinics, seem to work out best when each meeting is restricted to staff members of the same level. This permits of adapting the discussion to the experience background of the men in the various groups. When staff meetings are regarded as desirable, I believe they should be held on the firm's time, if feasible during working hours.

In closing, I would like to emphasize the need for guarding against the very natural inclination to concentrate on those in a group who appear to be the best prospects (and who need the least help) at the expense of those who may not immediately have demonstrated equivalent qualities and who need the most aid.

FORM-88-3M-41868-HH

CONFIDENTIAL

PERSONNEL REPORT

To Mr. .... Re: Mr. ....

Date .... **Assignment** ....

(Before preparing this report read **carefully** the instructions on the reverse.)

	E	G	F	P
1. **Auditing Ability**				
(a) Working papers				
(b) Technical ability				
(c) Application to work				
(d) Sense of responsibility				
2. **Professional qualifications**				
3. **Qualifications for self-expression**				
4. **Personal qualifications**				

5. **How do you classify him** (indicate by "x")

   Senior ( ) Light Senior ( )

   Semi-senior ( ) Junior ( )

6. **Ability to assume more responsible assignments**

   (a) Immediately Yes ( ) No ( )

   (b) Eventually Yes ( ) No ( )

Comments: ____

____

____

____

____

Signed ....

Date ....

(Reverse)

INSTRUCTIONS

These reports are **confidential** and should **not** be returned in a self-addressed firm envelope. Either deliver them to Mr. Ankers in person or mail them in a regular envelope addressed to his attention. The completed report should be returned **promptly** upon releasing the staff member from this assignment.

The purpose of these reports is to aid the firm in making the most effective use of the services of its staff members. Therefore, it is essential that the information called for by the check list on the reverse side hereof be furnished frankly, completely and carefully.

For each item listed in the first four questions, make a check in the appropriate column to indicate your rating of the staff member as: excellent (E), good (G), fair (F), or poor (P), bearing in mind his classification rank (Question 5). Comments should be made in the space provided whenever they are deemed necessary to permit a fair appraisal of the man. If, in your opinion, the man has any **outstanding** favorable qualifications or faults or serious shortcomings in necessary qualifications, they should be mentioned. In the latter case, it is desirable that you suggest what action might be taken to eliminate or reduce such shortcomings.

The following factors are suggested for consideration in making the required ratings:

Auditing ability

(a) **Working papers**

Complete (adequate)
Excessive information
Neat
Clear (easy to follow)
Adequate cross references

(b) **Technical ability**

Application of auditing procedures
Knowledge of accounting principles
Inquiry into accounting systems, internal control, etc.
Preparation of financial statements and schedules
Preparation of reports

(c) **Application to work**

Conscientious
Careful
Imaginative (originality)
Over-meticulous
Speed of performance

(d) **Sense of responsibility**

Carry out instructions
Self-reliant
Progressive (makes constructive suggestions, etc.)

Professional qualifications

Relations with client
Relations with other staff men
Respect confidential information
Professional interests
Dignity

Qualifications for self-expression

Ability to speak
Ability to write

Personal qualifications

General personality
Appearance
Respect for superiors
Conduct (moral character)
Outside interests
Qualities of leadership
Tact
Ambition
Reasoning ability
Perserverance
Diligence

PUBLIC ACCOUNTANTS' STAFF TRAINING PROGRAMS[1]

THOMAS D. FLYNN

ALONG WITH OTHER accounting firms we were faced during the war with the necessity of devoting more and more time to the training of our staff. As you know, the number of junior accountants turned out by our colleges during this period was cut to a mere trickle. Many of our accountants saw service in the armed forces while others went into war industries. As a result the quality of our staff was considerably impaired. To maintain our professional standards, we were forced into a more intensive training program. The cessation of the war, of course, has relieved but it has not cured the situation. We still find it necessary to devote a very considerable time to the continued training of our staff. In view of this condition, we are happy to see once again a healthy flow of qualified graduates from our colleges which I am sure will in time do much to improve the quality of the entire accounting profession. Does this mean that we will now begin to curtail our training program and perhaps abandon it altogether some time in the future? I think not. In the first place, we had a comprehensive program well before the war. During the war we merely intensified our efforts. Secondly, we have had such good results with the intensive training program that it is unlikely that we will reduce it to any significant extent.

REPORT DEPARTMENT

I should like to give you a brief summary of some of the main points of our staff training program in so far as our New York office is concerned. Before the war we felt that our juniors should spend a few months to a year in our Report Department before undertaking any staff assignments. Our Report Department carefully checks all reports which we issue in a number of different ways to insure their accuracy. This department proof reads the reports, checks them for mathematical accuracy, and verifies all internal references as well as any references to other sources such as prior years' reports. The Report Department is also intended to provide an independent check to see that the reports contain no errors in the application of accounting principles as far as can be determined from the reports themselves and that the requirements of the Stock Exchange, the SEC, and other governmental agencies have been met. We regard this as very valuable training for any junior accountant since it gives him an opportunity to obtain a thorough understanding of the end products which he will be required to produce later on in his auditing career. In addition, we have found that juniors starting out on the staff after training in the Report Department have a keener appreciation of the significance of auditing facts and a better sense of accounting values than if they start out on the staff without such training.

Practically all the juniors added to our staff in the last two or three years have been veterans. These men are reluctant to start their careers in the report department. They are anxious to launch their careers as rapidly as possible and they feel that they are losing valuable time unless they start out almost immediately with an assignment in the field. Since they are

[1] This paper was presented at the annual meetings of the American Accounting Association in New York in September, 1947.

older, more mature and in general have a very healthy attitude toward their work we feel that with them we can dispense with this tour of duty in the report department as a prelude to being on the staff. As a substitute for this rather lengthy preliminary training, however, we put them in the Report Department for a short period, generally from two to three weeks. We do this sometime during the first year before they have progressed very far in their training in order to give them an appreciation and understanding of our final reports. As the graduates turned out by the colleges become more nearly the normal age we probably shall revert to our pre-war practice of starting practically all our juniors off in the Report Department for a period of training there. While the veterans are reluctant to undertake this training primarily because of the time element, the staff men who have had such experience agree that it has been invaluable to them later in their careers.

AUDITING AIDS

We have in recent years spent a great deal of time in the development of auditing aids for distribution to our staff. One aid which we have found of great value in staff training has been our Auditing Instruction Book. This book is not intended to be a manual of auditing but rather to be a guide to a practical approach to auditing problems and procedures generally found in most audits. Integrated with this guide is a check list of important auditing points which must be considered in any intelligent and comprehensive auditing program.

We have also developed other aids. We have a bulletin, or hand book, which brings together and summarizes in convenient form information which is found in a number of scattered, and in some cases cumbersome, sources. We have sections, for example, on the SEC, on taxes, on bulletins of the American Institute of Accountants, and a variety of topics which we feel should be discussed for the benefit of the staff. We also have a model report containing a balance sheet, income and surplus statements, and a number of supplementary schedules. The report, in addition, sets out in considerable detail points that usually should be mentioned in connection with cash, accounts receivable, inventory, and other items on the balance sheet and profit and loss statements. Another auditing aid which we have found very helpful is an internal control questionnaire which lists a large number of questions which we feel should be answered in connection with any systematic review of internal control.

In varying degrees, of course, these aids are used by all members of our staff, including our managers. I would like to emphasize, however, that these aids are not intended to furnish the auditors with a mechanical and routine approach to any audit or that they should stifle initiative. It has been our experience that the alert and inquisitive auditor finds it a definite help rather than something that hinders and hampers his scope of activity. Moreover, we do not feel that any of the aids mentioned above are to be accepted without question. They are constantly undergoing change. We welcome criticism of them from the staff and from time to time we undertake major revisions to make them as up to date as possible.

TRAINING SCHOOLS

Each year we hold schools for our junior accountants. We generally run them somewhat as follows: A school consists of from ten to fifteen men, all of whom we hope will eventually develop into first-class senior accountants. We prefer for these men to have at least one busy season with us before attending the school since the question of specific procedures will seem so much more alive to them than if they have

had no practical experience whatsoever. These schools last from four to five weeks. We hold them in one of our staff rooms, five days a week, nine to five-fifteen with an hour for lunch and with two fifteen minute recesses, one in the morning and one in the afternoon. We also give them a study period of approximately an hour immediately after lunch. The morning sessions are devoted principally to a careful review of our Auditing Instruction Book and the check lists and are not so much concerned with learning procedures described therein as with an attempt to ascertain the reasons for such procedures. To this end, we bring in for discussion at appropriate places the bulletins published by the committees of the American Institute of Accountants, our model report, references to our bulletin book and to SEC material such as S-X regulations. The afternoon sessions are devoted to a review of a theoretical set of working papers which have gradually been developed in our schools during the last ten years. We attempt, where possible, to coordinate the work of the afternoon sessions with that of the morning sessions.

The review of the Auditing Instruction Book and the theoretical set of working papers covers about three weeks of the course. The remaining time is devoted to a number of other subjects. Approximately three days are spent in the review of our internal control questionnaire. A representative of our Tax Department spends one or two days in a broad survey of the tax laws and then guides them in the preparation of a tax return, based upon the working papers used in the afternoon sessions. We also review published accounts, 10-K's and actual related working papers. At the conclusion of the course, a day is devoted to the taking of the Orientation and Achievement tests developed by the Committee on the Selection of Personnel of the American Institute of Accountants. The schools are not run by the lecture method but rather more in the order of a seminar, in that we attempt to encourage discussion and active participation by those attending the school. In addition, in order to make the subject as alive as possible and to give it meaning, we refer to specific cases and illustrations drawn from our own auditing experience to support various points brought up for discussion.

Of course, the information, techniques, and procedures covered in these schools could be learned by experience on the job with capable supervision and with supplementary study and self improvement. From my own experience, however, these schools have hastened the process. They have provided a worthwhile connection with the theoretical training which is received in business schools and colleges and the practical knowledge which must be acquired before a staff man can be considered a fully qualified senior accountant.

MONTHLY MEETINGS

In addition to our schools we feel it desirable to have regular monthly meetings for our staff, to provide a forum for the discussion of current accounting problems. Perhaps you may be interested in how we run them. These meetings are held in one of our staff rooms and last from five until approximately seven o'clock, after which a group dinner is provided at one of the local restaurants for those attending the meeting. The meetings themselves are usually run by one partner and three managers, one of the managers acting as chairman. The basic idea followed in running these meetings is to encourage active participation and discussion by the staff. The managers and partner are present not so much for the purpose of lecturing on any particular subject as for the purpose of providing guidance, direction and cohesion to the meetings. As an indication of the subject

matter discussed at these meetings we discussed such varied topics as (1) the investigation of market values of inventories at and subsequent to the audit date, (2) the extent of vouching of maintenance and repairs, and (3) interim work which can be profitably performed in addition to a study of internal control, and the extent to which it can take the place of year-end work. While we usually discuss several topics at a meeting, we had a very successful meeting which was devoted almost exclusively to a case study of frauds.

MISCELLANEOUS

In addition to the program of staff training discussed above, we do other things to encourage the development of our staff. We distribute to them miscellaneous publications, bulletins of the American Institute of Accountants, tax guides, and various regulations of the SEC. We encourage the staff to make use of our library facilities and to the extent that we have unassigned time, we urge the staff to use the time productively in the review of audit work papers, in studying for CPA examinations, and in the reading of books on auditing and accounting.

The auditing aids which I have so far described are designed to supplement and not to replace actual experience. It is still necessary for the junior to come up against a variety of situations in actual practice in order to develop his auditing sense and to mature his judgment. We hope our training program will enable the juniors to absorb such experience much more quickly and completely. However, in addition to this program must go intelligent guidance and supervision by the seniors and managers of their assistants. Such guidance and supervision is at the very root of a satisfactory training of the staff.

THE TEACHERS' CLINIC

S. PAUL GARNER

EDITOR'S NOTE: Many of the experienced teachers, as well as some of the new ones, have developed devices and techniques for the presentation of certain of the knotty aspects of accounting, and it is felt that such suggestions might well be made available to the other members of the teaching profession through *The Teachers' Clinic*. Accordingly, contributions are hereby invited. Please address all correspondence to S. Paul Garner, School of Commerce and Business Administration, University, Alabama.

THE COURSE IN INTERNAL AUDITING

S. PAUL GARNER
University of Alabama

As a result of a recent discussion between members of the Executive Committee of the American Accounting Association and the Chairman of the Education Committee of the Institute of Internal Auditors, the Editor of this Department was asked to conduct a limited survey in order to determine the present status of the course in internal auditing. Since the results of the survey may be of interest to the readers of THE ACCOUNTING REVIEW, a brief résumé is given below.

The Institute of Internal Auditors has been active in the field of education for several years, and its several committees wish to cooperate in every way possible to further the adequate preparation of students for careers in internal auditing. Some case and text materials have already been prepared; these teaching aids are rapidly being augmented as more universities become interested in the subject matter.

In carrying out the survey 36 questionnaires were sent to specific persons in the same number of selected institutions. Most of the prominent schools of commerce and business administration were included in the group. Thirty replies were received. It is believed that the large percentage of replies indicates a growing interest in the field of internal auditing.

Five of the universities are now offering a course in internal auditing, but not necessarily every term. As might be expected, the prerequisites for the course vary. In most cases courses in general auditing and cost accounting are listed as essential.

Five additional schools are planning to offer the course in the near future, the specific date depending principally upon the availability of teachers.

Since ten institutions now offer the course or intend to do so in the immediate future, any question as to the appropriateness of its inclusion in university curricula seems reasonably well settled. Based on comments which the writer has received, there is still some sharp cleavage of opinion as to whether a separate course in internal auditing is desirable (see quotations below). Several teachers, for example, have expressed the feeling that this phase of auditing should and can be covered in the regular course (or courses) in auditing. One correspondent, for instance, thinks that the fields of external and internal auditing should be analyzed with a view to (1) determining the extent to which the subject matter to be covered by separate courses

would overlap, and (2) ascertaining the extent to which two such courses would justly be different. Having made this analysis and determination, he suggests that a study be made to determine the best method of treating the differences. Some possibilities for the future are: (1) Treating the auditing of each item on a common basis first, and then to discuss any differences from the standpoint of their applications in the respective areas, perhaps increasing the credit offered for the standard course in auditing by one credit-hour or so; (2) give the standard course in auditing, and add other chapters to present differences in the application of auditing procedures in the internal phase of the auditing activity, increasing the credit offered, if necessary; (3) continue to give the standard course in auditing, and add a new course in internal auditing to present different practices in the latter area (as is apparently being done by several schools now); (4) continue to give the standard course in auditing, and add a new course in internal auditing which will cover the subject from the beginning (all principles and procedures), just as has been done in the courses in external auditing for many years.

Some other general comments follow:

(1) I have just re-read the recent statement of the Institute of Internal Auditors on the *Responsibilities of the Internal Auditor* (which I believe to be an excellent one) and should like to raise a question as to whether a separate course in internal auditing is the thing needed, or whether emphasis should not be given to a whole series of supporting courses.

(2) Our course carries two semester units of credits, and emphasizes report writing and study of specific cases. It is open to seniors and graduates, and has a prerequisite of approximately three years of accounting study including courses in auditing. Our conception of internal auditing is that of an analytical investigative technique for the service of top management, and definitely not that of a substitute for the work of the independent public accountant.

(3) In our present auditing course, which is given for three semester hours credit, we are using both an auditing text and a book on internal auditing. Parallel assignments are made in both texts, but in terms of class discussion time, since much of the material in the internal auditing book is a duplication of verification procedures, I would estimate that something less than one third of our time is devoted to a discussion of the specialized aspects of internal auditing. We feel very strongly that our accounting students need at least a general acquaintance with the field of internal auditing, not only to make them aware of the existence of such a field, but generally to acquaint them with the objectives and method of approach of the internal auditor as a matter of generally useful information.

(4) I do not conceive of a course in internal auditing justifying university credit separate and apart from regular auditing courses. Much of the technique of auditing is the same whether done by public or internal auditors. What is needed is an extensive course in accounting procedure which includes internal check and control prior to studying auditing.

(5) It is felt that if the principles of auditing are covered in the regular auditing course, the student will have no difficulty in adjusting himself to a position in a internal auditing department.

(6) We believe that our single course in auditing is ample for the needs of our school at this time, and do not plan to add to the subject in the immediate future. Personally, I believe that the subject of internal auditing has not received the attention it deserves in our general auditing courses, when merely a casual mention is made of the subject in one or two of the chapters in several of the current auditing texts. I am teaching the subject this semester and am planning to emphasize the subject to the extent of the equivalent of a chapter in the text, plus frequent references to it in connection with various phases of the auditor's work.

(7) I am very dubious of the value of a course in internal auditing for the usual full-time undergraduate. We get good results with our course in auditing because a substantial number of the students have had accounting experience. A course in internal auditing for this same group would probably be worthwhile. I am inclined to believe that some knowledge of accounting work and records obtained through experience is a prerequisite to any worthwhile work in auditing.

(8) About all that we can say with respect to an offering in internal auditing is that the subject will be treated as a collateral to internal control

within one of our general auditing courses. I would estimate that approximately the equivalent of one semester hour of work will be attached to the subject matter of internal control and internal audit. It is my personal feeling that in any auditing course we should give much less attention to accounting theory than seems to have been done in the past and more to the methods of internal control. I am not sure that I would favor a special course in internal auditing as such, but I do believe that it should be treated somewhere within our auditing course offerings.

(9) I feel it is a very desirable course for those who wish to enter the non-public field of accounting.

(10) My thinking on the matter is naturally influenced by our program here, but it seems to me that there would be considerable duplication of material if courses were to be offered in internal auditing as well as independent auditing. It might be feasible to permit students to elect internal auditing as a substitute for the traditional course in auditing, so that students who have no intention of entering the field of public accounting would receive training which would be more in line with their later work.

(11) We do not offer a separate course in internal auditing. Our regular auditing course is given two hours a week for two semesters and carries four hours of credit. It is estimated that about one fifth of the time is devoted to matters of internal auditing. This time, of course, is spread over the course and does not represent any consecutive period. We are not planning to offer such a course, feeling that it is covered not only in the auditing course but also in our course on accounting systems.

(12) We feel that the subject of auditing should be rather carefully reviewed at this time. Our graduates need an understanding of the aspects of internal auditing as well as those of external auditing. Likewise, public accountants who come in to work with private business need a suitable background in the operation of internal auditing. We are accordingly interested in giving this area proper treatment, and no doubt this will be the result when we complete our re-organization. At the present I doubt that a specific course as such will be advocated.

(13) We feel that the subject of internal auditing is too narrow to justify an entire course on this subject. We are, however, giving some thought to a course covering the special features of controllership of which internal auditing would be a part. So far, however, I think our plan has not progressed beyond the conversation stage.

(14) First, we have a course in auditing in which we discuss the procedures commonly followed by public accounting firms and also give some little attention to the work of the internal auditor. Secondly, we offer a course in comptroller ship and we give approximately one sixth of the time in that course to the organization and functioning of the internal auditor. We do not contemplate any separate course being offered in this field, and it does not seem to me that there is justification for a full course being offered in this field alone. Incidentally, only yesterday the general auditor of the Standard Oil Company of California discussed the specific work and methods used by his department (consisting of a staff of twenty-nine people) talking for two hours to my class on the subject, and in discussion with him he expressly stated that he did not see any justification for a separate course in internal auditing. We are definitely in agreement with this.

(15) It is felt that there is a definite place for internal auditing as a course in our curricula. As presented to our students it is placed on a senior and graduate level with cost accounting and auditing as a preliminary requirement. The course is viewed as a correlation of accounting theory and practice. Emphasis is placed on the procedural responsibilities of the internal audit staff. The student is given a two week introduction to the organization of an internal audit office plus heavy emphasis on the relation between internal check and control and the duties of the internal auditor. In the subsequent four weeks the student receives a thorough indoctrination in procedure analysis which is followed by three additional weeks dealing with internal audit work papers and the audit report. We also take up in the latter part of the course the relation between the internal and external auditor.

In some of the schools now offering the course, guest lecturers from industry are invited to participate in the instruction. The use of such persons is regarded as being essential for securing the necessary practical applications of the several topics treated.

One topical outline now being used for the internal auditing course was given in this Department of The Accounting Review in the October 1947 issue (p. 416).

Another one is given below:

1. The Scope and Objectives of Internal Auditing
2. Organization of an Internal Auditing Staff and its Place in the Corporate Organization
3. Relationship of Internal Auditing to Public Accounting
4. Internal Control
5. Several weeks devoted to internal auditing practice and techniques as applied to specific projects including, but not limited to:
   (a) Examination of cash and receivables
   (b) Examination of the purchasing activities, inventories, etc.
   (c) Examination of fixed assets
   (d) Examination of accounts payable
   (e) Examination of the cost accounting system and the cost accounting department
   (f) Special investigations
6. Reports and follow-up of audit projects.

A METHOD OF ACCOUNTING FOR INTER-DEPARTMENTAL PROFITS

H. N. Broom
The University of Texas

Some companies, producing on a continuous-process, mass-production basis, and using process costs, transfer goods in process from one producing department to another at a profit instead of at cost. The transfer commonly is at market; that is, cost of the partly-processed goods as if purchased from outsiders. The purposes of the inter-departmental profit transfer are: (1) a determinant of the profit arising from the manufacture rather than the purchase of product sold, and (2) a determinant of departmental efficiency (as seen in the width of the market-minus-cost margin). The latter may also be the basis of computation of supervisors' bonus payments.

An often stated objection to the inter-departmental profit procedure is that it introduces into the accounts a profit unrealized by sale to outsiders. In the main, the gains of one department are cancelled by the higher costs of the next department. If there is a variation in starting and ending process and finished-goods inventories, however, cost of sales may show a higher figure. This can be overcome by eliminating inter-departmental profits from final inventories through the use of an inter-departmental profit reserve, which is adjusted on balance sheet dates. To do this, the final balance in the inter-departmental profit reserve must be accurately obtained in order to reduce the combined inventories.

Calculation of the final reserve balance may become very involved. Two methods which have been proposed are:

(1) Prepare two interim work sheets, one at cost and the other at cost plus inter-departmental profit, so that the difference in combined final process and finished goods inventories, as shown on the two work sheets, will give the final reserve balance.
(2) Use formulas.

The first of these, in practice, is difficult of accomplishment. Many companies do not have all transactions available in summary form for the preparation of these work sheets, and the handling of individual transactions on interim work sheets becomes an extended process. The second approach to the problem is not readily comprehended by beginning cost students, and is highly subject to error.

Accordingly, it is the purpose of this discussion to outline a third method which fits itself into the regular process-cost procedure. It is simpler and more easily un-

derstood by beginning cost students. It also tends to eliminate errors. The same results should be obtained, of course, under each of the three methods.

The problem and solution below constitute a demonstration of the technique advocated.

PROBLEMS

Bray Corporation, which uses the average-cost basis of process costing, has the following data available at December 31:

Work in process, December 1:

	Units	% Completion Materials	Conversion
Dept. A........	10,000	100%	60%
Dept. B........	9,000	100%	50%
Dept. C........	12,000	90%	50%

Work in process, December 31:

	Units	% Completion Materials	Conversion
Dept. A........	8,000	100%	50%
Dept. B........	9,000	100%	50%
Dept. C........	10,000	80%	25%

Factory Ledger account balances, December 1:

Materials in process, Dept. A.............	$20,000
Conversion cost in process, Dept. A........	18,000
Materials in process, Dept. B.............	27,000
Conversion cost in process, Dept. B........	18,000
Prior dept. cost, Dept. B (Cost, $45,000)...	49,500
Materials in process, Dept. C.............	4,320
Conversion cost in process, Dept. C........	15,600
Prior dept. cost, Dept. C (Cost, $144,000)..	165,000
Stores inventory..........................	386,000
General ledger account....................	677,920
Reserve for inter-departmental profit......	25,500

There were no starting balances in finished goods or accrued payroll accounts.

Units started and completed in dept. A during December, and transferred to Dept. B, were 32,000. All starting inventories were cleared during the month.

New materials requisitioned were: Dept. A, $77,500; Dept. B, $131,100; Dept. C, $21,680.

Final totals on the conversion-cost-incurred distribution sheet, by producing departments, were: Dept. A, $122,300; Dept. B, $163,350; Dept C, $100,650.

Direct labor amounted to $200,000, while indirect labor totaled $10,000. Payrolls paid were $205,600. Other conversion costs, including depreciation, amounted to $176,300.

Materials and supplies purchased, as recorded, totaled $5,740, while $3,000 worth, to which the company had title at December 31, were then in transit. Forty thousand units of goods completed were sold at fifty per cent mark-up; i.e., adjusted cost of sales is fifty per cent of sales.

Inter-departmental transfers are made at 110 per cent of reported costs, as pyramided.

Prepare:

(1) Quantity and equivalent production computations.
(2) Process cost summaries for producing departments.
(3) Finished goods schedule.
(4) Journal entry to adjust the reserve and cost-of-sales accounts as of December 31.

SOLUTION

Units Transferred = Starting Inventory Units + New Production Units − Ending Inventory Units:

Dept. A = 10,000 + 40,000 − 8,000 = 42,000
Dept. B = 9,000 + 42,000 − 9,000 = 42,000
Dept. C = 12,000 + 42,000 − 10,000 = 44,000

Equivalent Production = Units Transferred + % Completion (Ending Inventory Units) − % Completion (Starting Inventory Units):

Dept. A

Raw Materials = 42,000 + 1 (8,000) − 1 (10,000) = 40,000
Conversion Cost = 42,000 + 1/2 (8,000) − 3/5 (10,000) = 40,000

Dept. B

Raw Materials = 42,000 + 1 (9,000) − 1 (9,000) = 42,000
Conversion Cost = 42,000 + 1/2 (9,000) − 1/2 (9,000) = 42,000
Prior Dept. Cost = 42,000 + 1 (9,000) − 1 (9,000) = 42,000

Dept. C

Raw Materials = 44,000 + 4/5 (10,000) − 9/10 (12,000) = 41,200
Conversion Cost = 44,000 + 1/4 (10,000) − 1/2 (12,000) = 40,500
Prior Dept. Cost = 44,000 + 1 (10,000) − 1 (12,000) = 42,000

Dept. A—Process Cost Summary

	Raw Materials			Conversion Cost		
	EPU[1]	*UC*[2]	*Cost*	*EPU*	*UC*	*Cost*
Starting Inventory	10,000		$ 20,000	6,000		$ 18,000
New Production	40,000		77,500	40,000		122,300
Total	50,000	$1.95	$ 97,500	46,000	$3.05	$140,300
Ending Inventory	8,000	1.95	15,600	4,000	3.05	12,200
Transfers Out	42,000		$ 81,900	42,000		$128,100

Dept. B—Process Cost Summary

	Raw Materials			Conversion Cost		
	EPU	*UC*	*Cost*	*EPU*	*UC*	*Cost*
Starting Inventory	9,000		$ 27,000	4,500		$ 18,000
New Production	42,000		131,100	42,000		163,350
Total	51,000	$3.10	$158,100	46,500	$3.90	$181,350
Ending Inventory	9,000	3.10	27,900	4,500	3.90	17,550
Transfers Out	42,000		$130,200	42,000		$163,800

			Prior Dept. Cost		
	EPU	*IDPUC*[3]	*IDP*[4] *Cost*	*UC*	*Cost*
Starting Inventory	9,000		$ 4,500		$ 49,500
New Production	42,000		21,000		231,000
Total	51,000	$.50	$25,500	$5.50	$280,500
Ending Inventory	9,000	.50	4,500	5.50	49,500
Transfers Out	42,000		$21,000		$231,000

Dept. C—Process Cost Summary

	Raw Materials			Conversion Cost		
	EPU	*UC*	*Cost*	*EPU*	*UC*	*Cost*
Starting Inventory	10,800		$ 4,320	6,000		$ 15,600
New Production	41,200		21,680	40,500		100,650
Total	52,000	$.50	$26,000	46,500	$2.50	$116,250
Ending Inventory	8,000	.50	4,000	2,500	2.50	6,250
Transfers Out	44,000		$22,000	44,000		$110,000

			Prior Dept. Cost		
	EPU	*IDPUC*	*IDP Cost*	*UC*	*Cost*
Starting Inventory	12,000		$21,000		$165,000
New Production	42,000		73,500		577,500
Total	54,000	$1.75	$94,500	$13.75	$742,500
Ending Inventory	10,000	1.75	17,500	13.75	137,500
Transfers Out	44,000		$77,000		$605,000

Finished Goods Schedule

	Units	*IDPUC*	*IDP Cost*	*UC*	*Cost*
Starting Inventory	0		0		0
Transfers in	44,000		$150,700		$810,700
Total	44,000	$3.425	$150,700	$18.425	$810,700
Ending Inventory	4,000	3.425	13.700	18.425	73,700
Cost of Sales	40,000		$137,000		$737,000

[1] Equivalent production units.
[2] Unit Cost.
[3] Inter-departmental profit unit cost.
[4] Inter-departmental profit cost.

Schedule of Inter-Departmental Profit in Ending Inventory

Dept. B, Prior Dept. Cost	$ 4,500
Dept. C, Prior Dept. Cost	17,500
Finished Goods	13,700
Reserve Balance	$35,700

Reserve for Inter-Departmental Profit

Adjustment	$137,000	Balance	$ 25,500
		Dept. A	21,000
		Dept. B	52,500[5]
Balance	35,700	Dept. C	73,700[6]
	$172,700		$172,700
		Balance	$35,700

Adjusting Journal Entry

December 31 Reserve for Inter-Departmental Profit	$137,000	
Cost of Sales		$137,000
To reduce the reserve to the amount of inter-departmental profit still in inventories.		

[5] The Dept. B reserve credit is $21,000 less than the New Production IDP Cost on the Dept. C Process Cost Summary because that amount of Dept. A ID Profit was forwarded to Dept. C by Dept. B.

[6] Similarly, the Dept. C reserve credit is $77,000 less than the Transfers In IDP Cost on the Finished Goods Schedule because that amount of Depts. A and B ID Profit was forwarded thereto by Dept. C.

LIBRARIES FOR STUDENTS OF ACCOUNTING

Mary E. Murphy
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One of the most handicapping features of contemporary accounting instruction at both the undergraduate and graduate levels, in the opinion of the writer is the paucity of material available in most college and university libraries. By material is meant a wide variety of professional literature in the field of accountancy drawn from American and English sources, with the criterion of selection based upon the enlargement of the student's appreciation of important stages in the evolution of accounting theory and practice.

The writer has had the privilege and opportunity in recent months of examining a number of outstanding accounting libraries in various sections of the United States. Collections have varied in scope and excellence, their merit usually being closely correlated with the interests motivating the individual largely responsible for the purchase of materials, and the research pursued by faculties and students.

Perhaps it is not too much to say that the best example of the work of a single individual in building up an all-inclusive library is that of the late Professor Henry Rand Hatfield at the University of California at Berkeley. The zeal which drove Professor Hatfield to seek out both rare and modern treatises in accounting in all parts of the world finds no parallels on other campuses. In far too many instances the purchase of books and periodicals is such a haphazard affair that even complete sets, for example, of the *Journal of Accountancy*, Accounting Review, *Accountant*, and *American Economic Review* are not available for students or research workers. As a general rule publications

and research bulletins of recognized professional bodies, such as the American Institute of Accountants and the American Accounting Association, as well as the textbooks of the commercial publishers specializing in the business field, are not complete and this state of affairs greatly limits the potential development of intellectual pursuits of both advanced undergraduate and graduate students.

The list of accounting library deficiencies in some of the larger state universities, whose financial resources are not seriously limited, would cover several paragraphs. Prevailing conditions in library facilities lead the writer to emphasize that the American Accounting Association and the American Institute of Accountants should combine their efforts in the preparation of a list of basic books and magazines which they believe constitute a workable library for undergraduate and graduate students of accountancy. Any list which these groups might prepare would necessarily include the titles of treatises dealing with the historical background of accounting theory and the modern exemplifications of theory and technique. Representative materials, published in England, covering public and private accountancy would be included (1) to prevent the student's assuming a provincial attitude in his thinking, (2) by offsetting emphasis upon American methods through a study of recent British developments, including the enactment of the Companies Act, 1947, and (3) the research studies of the Institute of Chartered Accountants and the Society of Incorporated Accountants.

This is a fair indication of the type of reading matter which should be included in a comprehensive list by either the American Institute of Accountants or the American Accounting Association. In addition, an effort should be made to include recognized volumes in areas related to accountancy, such as economics, finance, law, and banking. Stress should be placed upon consecutiveness of materials to prevent the "spottiness" which now exists to such an extent that in some university libraries periodical issues for the current year only are available. In most of these institutions, too, a diligent search of the catalogue fails to reveal the yearbooks of the International Accounting Congresses, the publications and annual proceedings of the American Economic Association, the American Accounting Association, and the American Institute of Accountants, and other classics of accounting literature, such as the writings of Dickinson, Hatfield, Kester, May, Montgomery, Paton, Sprague, and others.

This paper is intended solely as an indication of what must be accomplished by the national associations of practicing accountants and by teachers of accountancy in the next few months if library staffs can receive proper direction and advice in the purchase of source materials. Far too much time and money have already been unwisely expended in the average college and university library for materials in accounting and related subjects. Unfortunately, the result in most cases has been (1) the acquiring of books of passing value, (2) the absence of consecutive collections of magazines of professional bodies in Britain and America, and (3) incomplete files of pamphlets of regulatory bodies such as the SEC and ICC, the decisions of courts and judges on accounting matters, and of the volumes which will go down in history as the permanent moulders of accounting philosophy.

If the plan outlined fails of accomplishment, the responsibility for the acqusition of adequate source materials for accounting students will rest with individual faculties on American campuses. In the opinion of the writer, however, a joint and cooperative program would produce more permanent and rational results.

PROFESSIONAL EXAMINATIONS

A Department for Students of Accounting

HENRY T. CHAMBERLAIN

THE following problems were prepared by the Board of Examiners of the American Institute of Accountants and were presented as the second half of the C.P.A. examination in accounting practice in May, 1948. The candidates were allowed four and a half hours to solve problems 1, 2 and either 3 or 4.

A suggested time schedule is given below:

Problem 1	90 minutes
Problem 2	45 minutes
Problem 3	90 minutes
Problem 4	60 minutes

No. 1

From the information below, prepare:

1. Columnar worksheet reflecting the transactions and assumptions set forth below, for the two-year period from January 1, 1946 through December 31, 1947.
2. A comparative balance-sheet of the partnership as of January 1 and December 31, 1946 and as of December 31, 1947.

The trial balance of AB, a partnership was as follows on January 1, 1946:

	Debit	*Credit*
Cash	$70,000	
Accounts receivable	50,000	
Notes receivable	40,000	
Merchandise inventories	35,000	
Land	85,000	
Buildings and equipment—less reserve for depreciation	15,000	
Investments—at cost	35,000	
Prepaid insurance	4,500	
Office supplies	3,000	
Bank loans		$ 45,000
Accounts payable		60,000
Accrued taxes		2,500
First mortgage 2% long-term notes		55,000
Capital accounts:		
A		100,000
B		75,000
	$337,500	$337,500

Profits and losses were to be shared equally by A and B.

As of December 31, 1946, C purchased for $125,000 in cash from partners A and B a third interest in the partnership; each partner agreed to transfer ⅓ of his individual capital account to C. Prior to C's admission, it was decided that a valuation reserve of $5,000 should be provided with respect to the investments; that a reserve for bad debts should be established in the amount of $10,000; and that the valuation of buildings and equipment should be reduced to $11,000. Profit sharing by C commenced on January 1, 1947.

As of December 31, 1947, D was admitted to the partnership and contributed the following assets from a business previously operated by him as a sole proprietor:

Cash	$80,000
Accounts receivable	70,000
Investments	10,000

The following liabilities incurred by D in his previous business were assumed by the new partnership:

Accounts payable	$20,000
Bank loans	30,000

As an inducement to merge his enterprise with the ABC partnership, D was allowed goodwill of $25,000. Profits were to be shared equally by A, B, C, and D in the new firm, commencing January 1, 1948.

Additional data to be used in the solution of this problem are as follows:

	Year ended December 31,	
	1946	*1947*
Profit of the firm	$19,000	$27,000
Drawings:		
A	10,000	7,500
B	7,000	6,000
C	—	14,000

For the purposes of simplicity, it is assumed that profits for each year were

realized in cash and that the balance-sheet of the firm on January 1, 1946 did not change during the two-year period, except as indicated in the terms of this problem.

No. 2

From the following trial balance, which was taken from the books of the Hoover Handkerchief Manufacturing Company as of April 30, 1948, prepare a balance sheet in which effect has been given to such changes as may be necessary in view of the treatment accorded by the company to the transactions described in the paragraphs below the trial balance:

Account	*Debit*	*Credit*
Cash	$ 310,000	
Accounts receivable	800,000	
Raw materials on hand	750,000	
Finished goods on hand	500,000	
Finished goods out on consignment	100,000	
Plant and machinery	1,460,000	
Prepaid expenses	5,400	
Sales returns and allowances	25,000	
Administrative salaries	65,000	
Cost of sales	2,350,000	
Traveling expenses	30,0 0	
Interest expense	10,570	
Accounts payable		$ 175,000
Notes payable		100,000
Accrued payroll		6,000
Accrued interest payable on 6% bonds		10,000
Capital stock—6% preferred		1,000,000
Capital stock—Common		1,416,000
6% bonds, due June 30, 1956		500,000
Sales		2,500,000
Surplus, December 31, 1947		520
Paid-in surplus		698,480
	$6,406,000	$6,406,000

(1) The company has purchased various lots of its $100 par value common stock, aggregating 840 shares, at an average price of $65.50 per share, for $55,020. In recording these transactions the company has cancelled the stock certificates and charged the Common Stock account with the par value of $84,000 and credited the Paid-in Surplus account with the difference of $28,980 between par and the cash paid therefor.

(2) Paid-in Surplus was previously credited with (a) premium at $20 per share on 15,000 shares of common stock issued, and (b) adjustments arising from the appraisal of plant and machinery bought at a receivers' sale, $398,000.

(3) 4½% Bonds of the face amount of $250,000 falling due on December 31, 1954, were issued on January 1, 1930, at a 10% discount. To June 30, 1946, $16,500 of this discount had been charged against profits and as of this date the entire issue of these bonds was retired at par and the unamortized discount charged to Paid-in Surplus.

(4) A new issue of $500,000, 6% ten-year bonds was effected as of July 1, 1946, at par. Expenses, incurred with respect to this issue, in the amount of $20,000 were charged to Paid-in Surplus.

No. 3

From the information below prepare a statement, supported by appropriate schedules, of the taxable income of Mr. Peter Phillips, as a basis for filing on Form 1040 his Federal income tax return for the calendar year 1947.

Mr. Phillips, a citizen and resident of the United States, files his Federal income tax return on a cash basis. He properly filed his 1947 Declaration of Estimated Tax and paid an estimated tax thereon of $5,000. A widower, he provides for the entire financial support of his two sisters.

Mr. Phillips' tax return for 1946 was filed on the basis of the books which he kept as a sole proprietor.

As of January 1, 1947, Mr. Phillips organized the partnership of Phillips, Fast and Garda. The partnership agreement includes the following provisions:

Capital contributions:	
Phillips	$ 50,000
Fast	40,000
Garda	60,000
	$150,000
Compensation to partners:	
Phillips, as managing partner	$ 12,000 per year
Fast	none
Garda	none
Interest on capital:	
6 per cent per year on capital contribution of each partner.	
Profit and loss ratio applicable to residual net income:	
Philips	50%
Fast	20%
Garda	30%

Fiscal year or period:
To end October 31 in each calendar year.
Basis of keeping books:
Accrual

As of January 1, 1947 the capital of the partnership was paid in as follows:

Phillips:
1,000 shares, stock of U. S. Industries (market value 1/1/47, $30,000, cost to Phillips, 7/15/37, $24,000).
Raw materials and work-in-process inventories, at the lower of cost or market, $20,000 (per books of Phillips, operating as sole proprietor); original cost, $21,500.

Fast:
Cash, $40,000

Garda:
Cash, $49,500
Ten 6% debenture bonds of Atlas Fastener Corporation, face values, $10,000; market value at 1/1/47, $10,500 original cost to Garda on 9/19/33, $10,200; interest payable January 1 and July 1.

A summary of the firm's income statements and applicable schedules for the fiscal period ending October 31, 1947 and for the two months ending December 31, 1947 are as follows:

Particulars	*Fiscal period ending Oct. 31 1947*	*Two months ending Dec. 31 1947*
Income statements:		
Gross profit on sales, including depreciation	$45,000	$11,000
Selling expenses	$ 7,500	$ 2,750
Administrative and general expenses	29,600	6,050
	$37,100	$ 8,800
Net operating profit	$ 7,900	$ 2,200
Other income and deductions (net)		
Net profit from sales of securities	$ 2,300	$ —
Dividends and interest from domestic corporations	1,300	500
	$ 3,600	$ 500
Interest on capital contributions	7,500	1,500
	$ 3,900	$ 1,000
Net income	$ 4,000	$ 1,200
Less—current withdrawals by partners (P/L ratio)	3,000	600
Net income transferred to capital accounts	$ 1,000	$ 600

Schedules:

Administrative and general expenses:

Salary of Peter Phillips	$10,000	$ 2,000
Office salaries	8,000	1,600
Rent and telephone	4,600	920
Legal and accounting	2,500	500
Taxes	1,250	250
Bad debts	1,000	200
Contributions to organized charities	750	500
Miscellaneous office expenses	1,500	80
	$29,600	$ 6,050

Net profits from the sales of securities:

Security	*Acquisition*	*Disposition*	*Cost*	*Proceeds*
Central Stores	200 shares Jan. 5, '47	Oct. 10, '47	$13,000	$10,000
Outlet, Inc.	100 shares Jan. 5, '47	June 20, '47	4,500	6,000
Gypsum Metals	100 shares Apr. 14, '47	June 20, '47	3,600	4,700
Distributors Co.	500 shares June 22, '47	Sept. 29, '47	8,000	10,700
			$29,100	$31,400
Net Profit			2,300	—
			$31,400	$31,400

Mr. Phillips' personal cash book and memoranda for 1947 disclosed the following:

Cash receipts—1947:

Compensation received from Phillips, Fast & Garda	$ 9,000
Directors' fees, less travel and accommodations, $80	320
Dividends from domestic corporations	2,600
Interest on capital invested in Phillips, Fast & Garda	2,250
Current cash withdrawals from Phillips, Fast & Garda against expected share of profits	1,500
Annuity under a life annuity contract acquired on January 1, 1942 for $100,000	5,000
Proceeds from sale of residence	28,000
Proceeds from sales of securities	28,000

Cash disbursements—

Tax (1947 estimated U. S. income tax)	$ 5,000
Taxes—	
Real property	750
State income—1946	4,250
City sales	120
Contributions	300
Legal fee paid to protect partnership interest	1,500
Cost of securities acquired during 1947	33,700
Amounts paid to two sisters	7,200
Other disbursements	1,150

Securities transactions:

		Acquisition	*Disposition*	*Cost*	*Exchange or Proceeds*
U. S. Industries, Inc.	1,000 shares	July 15, 1937	Jan. 1, 1947	$24,000	$30,000
Tire Supply Co.	100 shares	Jan. 6, 1947	—	10,450	—
Holyoke Tubing Inc.	100 shares	May 2, 1947	Aug. 8, 1947	7,100	6,450
Temple Metals, Inc.	200 shares	May 2, 1947	Sept. 6, 1947	6,500	4,300
Timplex, Ltd.	500 shares	Jan. 6, 1947	—	4,500	—
U. S. Tool Co.	100 shares	Jan. 6, 1947	—	5,150	—
Yoke Metals, Inc.	200 shares	April 8, 1936	Feb. 16, 1947	18,300	17,250

On January 2, 1947, Phillips sold for $28,000 a residence acquired by him for $30,000 on July 1, 1938, rented until September 30, 1941 and subsequently used by him until date of sale. Depreciation of $3,250 has been allowed during the rental period on the basis of a useful life of 30 years.

No. 4

From the following information concerning the operations of a municipal expendable revenue fund for the fiscal year ended April 30, 1948, prepare:

A. Entry or entries to close the books of the fund for the year ended April 30, 1948
B. A balance-sheet of the fund as of April, 30, 1948
C. A statement of revenue, expenditures and surplus for the year ended April 30, 1948

Information re Expendable Fund, for year ended April 30, 1948:

1.	Unappropriated surplus at May 1, 1947 consisted entirely of cash	$ 2,350
2.	Budget estimate of revenue	185,000
3.	Budget appropriations	178,600
4.	Tax levy $115,620, against which a reserve of $4,000 is set for estimated losses in collection	
5.	Tax receipts, $112,246, with penalties of $310 in addition	
6.	Receipts from temporary loans $20,000, all of which were repaid during period with interest of $300	
7.	Balance of encumbrances unliquidated, April 30, 1948	3,250
8.	Vouchers approved for expense	146,421
9.	Vouchers approved for capital expenditures	21,000
10.	Vouchers approved for payment of bonds falling due during the year, $5,000 and for interest on bonds, $2,000.	
11.	Miscellaneous revenue received	74,319
12.	Rebate of current year's taxes collected in error	240
13.	Warrants issued and payable on demand	169,400
14.	Refund on an expense voucher on which an excess payment was made	116

Solution to Problem 1

A, B, C and D
Working Papers
January 1, 1946 to December 31, 1947

	Trial Balance January 1, 1946		Transactions and Adjustments		Trial Balance December 31, 1946		Transactions and Adjustments		Trial Balance December 31, 1947	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	$70,000.00		(b) $19,000.00	(c) $17,000.00	$72,000.00		(g) $80,000.00 (e) 27,000.00	(f) $27,500.00	$151,500.00	
Accts. Recble	50,000.00				50,000.00		(g) 70,000.00		120,000.00	
Notes Recble	40,000.00				40,000.00				40,000.00	
Merchandise Inventory	35,000.00				35,000.00				35,000.00	
Land	85,000.00				85,000.00				85,000.00	
Buildings and Equipment (net)	15,000.00			(a) 4,000.00	11,000.00				11,000.00	
Investments	35,000.00				35,000.00		(g) 10,000.00		45,000.00	
Ppd. Insurance	4,500.00				4,500.00				4,500.00	
Office Supplies	3,000.00				3,000.00				3,000.00	
Bank loans		45,000.00				45,000.00		(g) 30,000.00		75,000.00
Accts. payable		60,000.00				60,000.00		(g) 20,000.00		80,000.00
Accrued Taxes		2,500.00				2,500.00				2,500.00
First mortgage notes		55,000.00				55,000.00				55,000.00
Capital—A		100,000.00	(a) 9,500.00 (b) 10,000.00 (d) 30,000.00	(c) 9,500.00		60,000.00	(f) 7,500.00	(e) 9,000.00		61,500.00
Capital—B		75,000.00	(a) 9,500.00 (c) 7,000.00 (d) 22,666.67	(b) 9,500.00		45,333.33	(f) 6,000.00	(e) 9,000.00		48,333.33
	$337,500.00	$337,500.00								
Reserve for loss on investments				(a) 5,000.00		5,000.00				5,000.00
Reserve for bad debts				(a) 10,000.00		10,000.00				10,000.00
Capital—C				(d) 52,666.67		52,666.67	(f) 14,000.00	(e) 9,000.00		47,666.67
					$335,500.00	$335,500.00				
Goodwill							(g) 25,000.00		25,000.00	
Capital—D								(g) 135,000.00		135,000.00
									$520,000.00	$520,000.00

KEY

(a) To adjust building and equipment account and to provide for loss on accounts receivable and investments.
(b) To credit partners for profit of 1946
(c) To charge partners for drawings in 1946
(d) To record the admission of C
(e) To credit partners for profit of 1947
(g) To record admission of D.

Solution to Problem 1

COMPARATIVE BALANCE SHEETS

	A and B January 1, 1946	*A, B and C December 31 1946*	*A, B, C and D December 31 1947*
Current Assets			
Cash	$ 70,000.00	$ 72,000.00	$151,500.00
Accounts Receivable (less reserve of $10,000.00, December 31, 1946 & 1947)	50,000.00	40,000.00	110,000.00
Notes receivable	40,000.00	40,000.00	40,000.00
Merchandise inventory	35,000.00	35,000.00	35,000.00
Office supplies	3,000.00	3,000.00	3,000.00
Prepaid insurance	4,500.00	4,500.00	4,500.00
Total Current Assets	$202,500.00	$194,500.00	$344,000.00
Investments (less reserve of $5,000.00 December 31, 1946 and 1947)	$ 35,000.00	$ 30,000.00	$ 40,000.00
Property, plant and equipment			
Land	$ 85,000.00	$ 85,000.00	$ 85,000.00
Buildings and equipment (net)	15,000.00	11,000.00	11,000.00
	$100,000.00	$ 96,000.00	$ 96,000.00
Goodwill			25,000.00
Total Assets	$337,500.00	$320,500.00	$505,000.00
LIABILITIES			
Current Liabilities			
Bank loans	$ 45,000.00	$ 45,000.00	$ 75,000.00
Accounts payable	60,000.00	60,000.00	80,000.00
Accrued taxes	2,500.00	2,500.00	2,500.00
	$107,500.00	$107,500.00	$157,500.00
First mortgage 2% long-term notes	$ 55,000.00	$ 55,000.00	$ 55,000.00
Capital			
A	$100,000.00	$ 60,000.00	$ 61,500.00
B	75,000.00	45,333.33	48,333.33
C		52,666.67	47,666.67
D			135,000.00
	$175,000.00	$158,000.00	$292,500.00
Total Liabilities	$337,500.00	$320,500.00	$505,000.00

Solution to Problem 2

Hoover Handkerchief Manufacturing Company
Balance Sheet
April 30, 1948
Assets

Current Assets			
Cash		$ 310,000.00	
Accounts receivable		800,000.00	
Inventories:			
Finished goods	$600,000.00		
Raw materials	750,000.00	1,350,000.00	
Prepaid expenses		5,400.00	
Total current assets			$2,465,400.00
Plant and machinery			1,460,000.00
Deferred bond issue expense			16,333.33
			$3,941,733.33

Liabilities

Current Liabilities			
Notes payable		$ 100,000.00	
Accounts payable		175,000.00	
Accrued payroll		6,000.00	
Accrued interest on bonds		10,000.00	
Total current liabilities			$ 291,000.00
6% bonds, due June 30, 1956			$ 500,000.00
Capital stock, paid-in surplus and deficit			
Capital stock—6% preferred		$1,000,000.00	
Capital stock—Common, $100 par value		1,500,000.00	
Paid-in surplus		300,000.00	
Earned surplus:			
Balance, December 31, 1947 (deficit)	*$10,980.00		
Net income, four months ended April 30, 1948	18,733.33	$ 7,753.33	
Capital surplus from appraisal		398,000.00	
		$3,205,753.33	
Less treasury stock, at cost		55,020.00	3,150,733.33
			$3,941,733.33

* Red.

NOTE: The reacquired shares are treated as treasury stock. The problem states that the certificates for the reacquired shares have been cancelled but it does not state that the formal capital has been reduced.

Solution to Problem 3

Peter Phillips

Statement of Taxable Income for Calendar Year 1947

Adjusted gross income:		
Directors fees, less travel and accommodation expense, $80.00		320.00
Dividends from domestic corporations		2,600.00
Other income:		
Annuity income (Schedule B)	$ 3,000.00	
Partnership income (Schedule A)	13,725.00	
Capital loss (Schedule C)	*850.00	15,875.00
Adjusted gross income		$18,795.00
Other deductions:		
Contributions:		
By partnership	$ 375.00	
Other contributions	300.00	675.00
Taxes:		
Real property taxes	750.00	
State income tax	4,250.00	
City sales tax	120.00	5,120.00
Miscellaneous:		
Legal fees paid to protect partnership interest		1,500.00
		$ 7,295.00
Net taxable income		$11,500.00

* Red.

Solution to Problem 3

Schedule A

Peter Phillips

Computation of Taxable Income for the Year 1947 from Partnership of Phillips, Fast and Garda

Net operating profit of partnership for fiscal period ended October 31, 1947		$ 7,900.00
Add:		
Salary of Peter Phillips	$10,000.00	
Contribution to organized charities	750.00	
Dividends and interest from domestic corporations	1,300.00	12,050.00
Ordinary net income of partnership		$19,950.00
Capital gains of partnership (Schedule A-1)		$ 3,800.00
Contributions of partnership		$ 750.00

Distribution of Profits

	Salary	*Interest on Capital*	*Balance of Profit*	*Total*	*Capital Gains*	*Contributions*
Phillips	$10,000.00	$2,500.00	$1,225.00	$13,725.00	$1,900.00	$375.00
Fast		2,000.00	490.00	2,490.00	760.00	150.00
Garda		3,000.00	735.00	3,735.00	1,140.00	225.00
	$10,000.00	$7,500.00	$2,450.00	$19,950.00	$3,800.00	$750.00

Solution to Problem 3

Schedule A-1

Phillips, Fast & Garda
Capital Gains and Losses

Description and Number of Shares	*Date Acquired*	*Date Sold*	*Sales Price*	*Cost Basis*	*Gain or Loss**	*Gain or Loss* to be Taken into Account*
Long-term						
Central Stores—200...	1/5/47	10/10/47	$10,000.00	$13,000.00	$3,000.00*	$1,500.00*
Distribution:						
Phillips						$750.00*
Fast						300.00*
Garda						450.00*
Short-term						
Outlet, Inc.—100.......	1/ 5/47	6/20/47	$ 6,000.00	$4,500.00	$1,500.00	$1,500.00
Gypsum Metals—100...	4/14/47	6/20/47	4,700.00	3,600.00	1,100.00	1,100.00
Distributors Co.—500...	6/22/47	9/29/47	10,700.00	8,000.00	2,700.00	2,700.00
						$5,300.00
Distribution:						
Phillips						$2,650.00
Fast						1,060.00
Garda						1,590.00

* Red.

Schedule B

Peter Phillips
Income from Annuity

Cost of Annuity 1-1-1942	$100,000.00
Total Amount received this year	$ 5,000.00
3% of cost of annuity	$ 3,000.00

Schedule C

Peter Phillips
Capital Gains and Losses

Description and Number of shares	*Date Acquired*	*Date Sold*	*Sales Price*	*Cost Basis*	*Gain or Loss**	*Gain or Loss* to be taken into Account*
Long-term						
U. S. Industries Inc.—100...			(Note)			
Yoke Metals, Inc.—200.....	4/8/36	2/16/47	$17,250.00	$18,300.00	$1,050.00*	$525.00*
Residence.................	7/1/38	1/ 2/47	28,000.00	26,750.00	1,250.00	625.00
From Phillips, Fast & Garda (Schedule A-1)						750.00*
Total						650.00*
Short-term						
Holyoke Tubing, Inc.—100...	5/2/47	8/8/47	$6,450.00	$7,100.00	$ 650.00*	$ 650.00*
Temple Metals Inc.—200.....	5/2/47	9/6/47	4,300.00	6,500.00	2,200.00*	2,200.00*
From Phillips, Fast & Garda (Schedule A-1)						2,650.00
Total						$ 200.00*
Amount of loss deductible						$ 850.00*

NOTE: The contribution of assets to a partnership by a partner does not result in a sale or exchange to which gain or loss can be attributed, but the basis in the partnership is the basis in the hands of the transferor.

* Red.

Solution to Problem 4

A. The following entries are made to record the transactions for the year and to close the books of the fund.

(1)		
Estimated revenues	$185,000.00	
Estimated budget surplus		$185,000.00
To record estimated revenues		
(2)		
Estimated budget surplus	$178,600.00	
Appropriations		$178,600.00
To record appropriations		
(3)		
Taxes receivable	$115,620.00	
Reserve for uncollectible taxes		$ 4,000.00
Revenue from taxes		111,620.00
To record tax levy and provision for uncollectible taxes		
(4)		
Cash	$112,556.00	
Taxes receivable		$112,246.00
Miscellaneous revenues		310.00
To record collection of taxes and penalties		
(5)		
Cash	$ 20,000.00	
Loan payable		$ 20,000.00
To record temporary loan		
(6)		
Loan payable	$ 20,000.00	
Appropriation expenditures—expenses	300.00	
Cash		$ 20,300.00
To record payment of loan and interest		
(7)		
Appropriation encumbrances	$ 3,250.00	
Reserve for encumbrances		$ 3,250.00
To record unliquidated encumbrances		
(8)		
Appropriation expenditures—expenses	$146,421.00	
Appropriation expenditures—capital additions	21,000.00	
Appropriation expenditures—bond retirement	5,000.00	
Appropriation expenditures—bond interest	2,000.00	
Vouchers payable		$174,421.00
To record appropriation expenditures		
(9)		
Cash	$ 74,319.00	
Miscellaneous revenues		$ 74,319.00
To record collections from miscellaneous sources		
(10)		
Taxes receivable	$ 240.00	
Cash		240.00
To record refund of taxes collected in error		
(11)		
Vouchers payable	$169,400.00	
Cash		$169,400.00
To record payment of vouchers payable		
(12)		
Cash	$ 116.00	
Vouchers payable		$ 116.00
To record refund of over-payment of voucher		
(13)		
Reserve for uncollectible taxes	$ 386.00	
Revenue from taxes		$ 386.00
To adjust reserve to amount of uncollected taxes		

(14)

Revenue from taxes	$112,006.00	
Miscellaneous revenues	74,629.00	
Estimated revenues		$185,000.00
Unappropriated surplus		1,635.00
To close revenue and estimated revenue accounts		

(15)

Appropriations	$178,600.00	
Appropriation encumbrances		$ 3,250.00
Appropriation expenditures—expenses		146,721.00
Appropriation expenditures—capital additions		21,000.00
Appropriation expenditures—bond retirement		5,000.00
Appropriation expenditures—bond interest		2,000.00
Unappropriated surplus		629.00
To close appropriation expenditures and appropriation accounts		

(16)

Estimated budget surplus	$ 6,400.00	
Unappropriated surplus		$ 6,400.00
To close budget surplus account		

Solution to Problem 4

B

City of——————
Statement of Revenue, Expenditures and Surplus
Year Ended, April 30, 1948

Revenues:		
Taxes	$112,006.00	
Miscellaneous sources	74,629.00	$186,635.00
Appropriation expenditures and encumbrances:		
Expenses	$146,721.00	
Capital additions	21,000.00	
Bond retirement	5,000.00	
Bond interest	2,000.00	
Encumbrances	3,250.00	$177,971.00
Excess of revenues over expenditures and encumbrances		$ 8,664.00
Unappropriated surplus, May 1, 1947		2,350.00
Unappropriated surplus, April 30, 1948		$ 11,014.00

City of——————
Balance Sheet—Expendible Revenue Fund
April 30, 1948

ASSETS

Cash		$ 19,401.00
Taxes receivable	$ 3,614.00	
Less reverse for uncollectible taxes	3,614.00	—
		$ 19,401.00

LIABILITIES

Vouchers payable		$ 5,137.00
Reserve for encumbrances		3,250.00
Surplus:		
Balance, May 1, 1947	$ 2,350.00	
Excess of revenues over expenditures and encumbrances	8,664.00	11,014.00
		$ 19,401.00

ASSOCIATION NOTES

E. BURL AUSTIN

1949 OFFICERS

At the annual convention, held in Memphis on September 9 and 10, the following were elected to serve as the officers of the American Accounting Association for the year 1949:

President:

ROBERT L. DIXON, University of Michigan

Vice Presidents:

HALE L. NEWCOMER, University of Illinois
HARRY H. WADE, University of Iowa
JOHN H. ZEBLEY, JR., Turner, Crook and Zebley

Secretary-Treasurer:

C. F. CHIZEK, University of Chicago

Editor, ACCOUNTING REVIEW:

FRANK P. SMITH, University of Rochester

Director of Research:

PAUL J. GRABER, University of Tulsa

Past Presidents:

ERIC L. KOHLER, Economic Cooperation Administration
THOMAS W. LELAND, A & M College of Texas
HERMANN C. MILLER, Ohio State University

ARIZONA

University of Arizona:

MERLE MOORE, Tucson CPA, was employed during the year 1947–48 to teach the auditing course.

CALIFORNIA

Visiting professors in the summer session included JOHN G. BLOCKER, University of Kansas, ALBERT B. CARSON, U.C.L.A., ROBERT L. DIXON, University of Michigan, CHARLES W. LAMDEN, San Diego State College, EDWIN L. THEISS, University of Illinois, and LESLIE WONG, University of British Columbia.

Stanford University:

BARRETT F. MCFADDEN has resigned to open an office to engage in public practice. He addressed the May meeting of the San Francisco chapter of NACA on the subject "Management Requirements for Adequate Cost Control."

J. HUGH JACKSON was recently made international treasurer of Kiwanis International, and is now a trustee of Teachers Insurance and Annuity Association.

University of San Francisco:

M. P. KILGORE has joined the staff. A. D. MCNEIL has been appointed lecturer in charge of CPA review and refresher courses.

MAURICE GREEN recently passed the CPA examination.

LEON SCHILLER recently conducted a special tax problems course for lawyers at Hastings School of Law in San Francisco.

COLORADO

Regis College:

WILLIAM J. CARSON and V. JAMES MOORE have been added to the staff as instructor and lecturer, respectively.

University of Colorado:

H. I. ARENSON has returned from a year's leave spent as chief accountant for the state of Colorado.

H. W. KENDRICK is now serving as president of the grand council of Beta Alpha Psi, national honorary professional accounting fraternity.

DISTRICT OF COLUMBIA

Catholic University of America:

Accounting staff consists of associate professor PAUL J. FITZPATRICK, head of department, assistant professor BRIAN A. KIRN, as instructor DUMAS L. MCCLEARY, and as lecturers WILLIAM B. PAUL, W. BALDWIN BUCHANAN, EDWARD C. MOYNIHAN, and MORTIMER B. DANIELS.

GEORGIA

Emory University:

E. E. BESSENT has become Chief Accountant for Emory University.

L. E. CAMPBELL was re-elected Secretary of the Georgia Society of CPA's.

The Georgia Association of Accounting Instructors had its annual meeting in May at Emory University. Officers elected were: president, H. M. HECKMAN, University of Georgia; vice-president, NOAH WARREN, Georgia Tech; secretary-treasurer, L. E. CAMPBELL, Emory University.

ILLINOIS

Northwestern University:

EDWARD RENNHACK has been appointed instructor in accounting.

Southern Illinois University:

William Matthies has joined the staff and Susie Ogden is on leave to work toward her doctorate.

Kansas

University of Kansas:

Keith Weltmer and Wiley Michell have been promoted from instructor to assistant professor.

De Witt C. Dearborn and Leo Poland have been added to the staff as assistant professor and instructor, respectively.

Harold Nielson and Arnold Warger, instructors, have resigned.

J. Joe Biery recently addressed the Purchasing Agents Association in Kansas City on the subject "Budgets and Reports to Management."

University of Wichita:

The accounting staff for fall consists of William F. Crum, associate professor and head of department, assistant professors Robert M. Ryan and Malcolm C. Black, and Robert E. Baird as instructor, the latter newly appointed.

William F. Crum is a member of the board of directors of the Wichita Chapter of NACA, and is serving as employment director.

Kentucky

University of Kentucky:

Additions to the staff include Homer C. Lewis and Robert J. Cojeen as assistant professors and Powers Jones as instructor.

W. E. Beals will be on sabbatical leave in 1948–49 to complete work on his doctorate.

Massachusetts

Massachusetts Institute of Technology:

George Smith has been appointed as instructor.

John A. Beckett recently addressed the Boston chapter, Internal Auditors Association, on the subject "The Internal Auditor's Concern with Organization."

Ronald H. Robnett recently addressed the Baltimore chapter of NACA on "Sponsored Research of M. I. T. and Its Relation to the Educational Program."

New Mexico

University of New Mexico:

Richard E. Strahlem has been promoted to the rank of professor, and was appointed acting comptroller of the University in April to succeed Tom L. Popejoy, who became president of the University.

New York

University of Rochester:

Frank P. Smith has been made Dean of the Graduate School.

Cornell University:

William H. Childs taught in the summer session at College of the City of New York.

John Farr, instructor in hotel accounting in the School of Hotel Administration, is on a year's leave of absence.

Pace Institute:

Alvin C. Hirsch was recently elected president of the Pace Alumni Association.

College of the City of New York:

E. J. Fjeld has been elected chairman of the department of accounting for a period of three years.

The following promotions have been made: to professor, E. J. Fjeld and Emanuel Saxe; to associate professor, Stanley B. Tunick; to assistant professor, Nathan Seitelman, John N. Myer, and Bernard Eisen.

Emanuel Saxe is managing editor of the *New York Certified Public Accountant*, and is also director of technical services and research of the New York Society, as well as chairman of its committee on education.

Stanley B. Tunick and Benjamin Neuwirth were elected directors of the New York Society of CPA's. Tunick will be on sabbatical leave in 1948–49.

Clarkson College:

Alwyn Carty, Jr., and George Risley left for the summer to do further graduate work.

Ohio

University of Dayton:

Joseph W. Jackson has been appointed to the staff. John C. Leibfritz has been granted leave of absence to do graduate work at the University of Michigan.

Other full-time day school staff members are D. B. Springer, Francis G. McGovern, Quentin C. Roche, Joseph F. Updyke, and Joseph E. Tolle.

Oklahoma

University of Tulsa:

M. H. Diels and Allan M. Early served as lecturers during the summer term.

The University of Tulsa second annual Conference of Accountants, May 13 and 14, was co-sponsored with the Oklahoma Society of CPA's the Oklahoma Society of PA's, the Oklahoma Petroleum Accountants Society, and local chapters of NACA and the Institute of Internal Auditors.

Oklahoma A. and M. College:

B. F. Harrison was recently appointed a member of the Oklahoma State Board of Accountancy.

Oregon

Oregon State College:

Staff appointments include Ralph L. Boyd as associate professor, Donovan D. McPherson as instructor.

Resignations include Byron L. Newton to North Texas State College, Irving K. Christiansen to San Jose State College, and William M. Ulrich to do graduate work at University of California.

Pennsylvania

Lehigh University:

Carl E. Moore and Thomas C. Kubelius have been appointed as instructors.

South Dakota

University of South Dakota:

Arthur Volk has been added to the staff as instructor.

Texas

North Texas State College:

Returning former faculty members are Byron Newton as professor of accounting, from Oregon State College, and Tom Rose as associate professor, from graduate studies at N. Y. U.

A. B. Short will go to University of Wyoming in September as professor of accounting.

Nelson G. Sullivan addressed the Texas Association of University Professors of Accounting in Fort Worth recently on the subject of accounting education in Texas colleges.

Texas Technological College:

T. C. Root, dean of business administration and head of the department of accounting, left July 1 to become assistant to the president and professor of finance it Southern Methodist University.

Utah

University of Utah:

Elmer R. Young has been appointed as assistant professor.

Virginia

Virginia Polytechnic Institute:

H. J. Dekker has resigned to become Treasurer of VPI.

BOOK REVIEWS

Frank P. Smith

Hotel Accounting (Revised Edition). Ernest B. Horwath and Louis Toth. (New York: The Ronald Press Company, 1948. Pp. 497. $7.00.)

This is the first revision of this standard text since its publication twenty years ago. Accordingly, a rather thoroughgoing revision would seem necessary. The authors, well known in the hotel accounting field, have brought their book up to date with a minimum of change in the original pattern.

The new edition, like its predecessor, follows the procedure of the American Hotel Association as outlined in the Uniform System of Accounts for Hotels. The intent of the authors has apparently been to prepare a book which would serve adequately as a text and at the same time be sufficiently clear and understandable to benefit those without formal accounting training. Furthermore, while the title of this book is Hotel Accounting, it contains considerable background material on hotel administration. Though most of the discussion is aimed at the transient type hotel of approximately four hundred rooms, the problems of the residential hotel are not overlooked. The illustrations, which are numerous, depict forms actually in use in the typical hotels.

The material contained in the book is offered in a clear, detailed style. This concentration on detail is perhaps best illustrated in the four chapters on food control. Here the allocation of costs, apportioning of food and control of waste is quite carefully outlined.

Hotel accounting has, of course, been subjected to many changes within the last twenty years. Some changes have evolved from within, others have been imposed by outside forces, such as social security, state unemployment compensation, etc. In order to take cognizance of these changes many parts of the original text have been expanded, condensed, or otherwise altered. In addition, several new chapters have been added.

Though fixed assets and their depreciation were examined in the first edition, an entire chapter has been set aside for this subject in the current edition. This expansion was deemed desirable by the authors because, as they state in the new preface, "The problem of depreciation of hotel buildings . . . is much better understood today than it was twenty years ago."

The second additional chapter is entitled Beverage Cost Accounting and was necessitated by the repeal of prohibition. This chapter contains the principles of beverage costing plus certain short cut methods of arriving at unit costs.

The third new chapter contains a discussion of Hotel Statistics. Various tools and methods of gauging operating efficiency and making financial analyses are contained in this discussion.

The last chapter to be added concerns Leases and Other Agreements. This exposition sets forth those matters to be considered in preparing and negotiating various agreements.

Finally, there has been added some information in the way of appendices. Appendix A contains a reprint of a booklet by the authors entitled Simplified System of Accounts for Small Hotels. This is a brief but ample discussion for the small hotel proprietor who has a knowledge of elementary bookkeeping. Appendix B contains illustrations of the many statements and schedules prepared by a typical hotel of four hundred and forty rooms. Appendix C, entitled Operating Statistics, contains various financial ratios for hotels of different sizes for the past several years.

As in the case of the original edition, this revision has been carefully prepared and contains a wealth of detailed information. Should this book be used as a text, it would be necessary to turn to some supplementary source for problem material inasmuch as none is incorporated in the revision.

F. S. Kaulback, Jr.

University of Virginia

Developments in Cost Accounting. The Institute of Chartered Accountants in England and Wales. (London: Gee & Co., 1947. Pp. 52. 9s. 4d.)

This is the text of a unanimous report prepared by the Cost Accounting Sub-Committee of the Taxation and Financial Relations Committee and presented to the Council of the Institute of Chartered Accountants in England and Wales. Although the opinions expressed in the report may not necessarily be those of the Council, the text may be considered as a significant and authoritative statement on the present trends in the field of cost accounting in Great Britain.

The main purpose of the report is to call the attention of the profession to prevailing practices which are inefficient and inadequate and to make recommendations for improvement. In this respect it is illuminating that the report lays special stress on the merits of standard costs and the advantages connected with careful budgeting. Apparently these methods are gaining ground in Great Britain although their progress seems to be hampered by the inertia of conservative business men and accountants.

The report emphasizes from the outset that sound methods of cost accounting should attribute as much importance to cost control as to cost ascertainment. The accounting department of an industrial concern fails to make its proper contribution to business if cost figures are either misleading or do not allow the management to take appropriate and instantaneous action. With increased competition only standard costs and budgeting provide adequate means for gauging the performance of production departments. Variances from standards call for careful investigation and eventual adjustment.

Besides insisting on the superiority of standard costs, the report also stresses the necessity for a careful allocation of overhead and condemns as dangerous any arbitrary and haphazard methods which result in seri-

ous errors by over-charging certain departments and under-charging others. The problem of fluctuations in output also receives consideration in the report. It points out that overhead may not be entirely absorbed by manufacturing if a factory operates below capacity. The unabsorbed overhead in that case does not represent a drop in efficiency but results from a drop in output, or "volume variance." In any case, overhead should not be charged to manufacturing without giving consideration to fluctuations in output. Otherwise costs will be raised in bad times when the factory operates below capacity and lowered in good times when it operates at normal or even above normal capacity.

The report advocates the adoption of uniform accounting schemes for entire industries. Some progress has been made in this direction but much remains to be done. The authors of the report believe that the difficulties are not insurmountable.

Another interesting point is that the report refers in at least one spot to the difference between average total, or all-inclusive, cost and marginal cost, that is to say, the cost of filling additional orders. If a factory operates below capacity, the report points out, it may be profitable to accept new orders even though overhead costs are not entirely met.

Incidentally, the report deplores the lack of suitable textbooks in Great Britain. It is hoped that this gap will soon be filled since a number of satisfactory treatises are available in the United States.

On the whole, the report contains nothing new on cost accounting but shows that strenuous efforts are being made in Great Britain to improve the existing methods and to bring them up to date by introducing standard costs, budgeting, and uniform procedure within the same industry. The formulation of uniform cost accounting schemes is rightly considered as a new challenge to the profession.

RAYMOND DE ROOVER
Wells College

Applied Bookkeeping. (College Edition, Revised.) D. Walter Morton (Deceased) and Ralph E. Berry. (Los Angeles: Charles R. Hadley Company, 1947. Pp. vii, 232. $3.00.)

Applied Bookkeeping is a textbook designed to give students training in bookkeeping practice and to provide them with an introduction to the principles of accounting. While the emphasis is placed on technique—appropriate for what is labeled a "bookkeeping text"—considerable space is devoted to explanation of underlying principles.

To make the text content more understandable and interesting to the reader, two-column typography and pictographs have been utilized, in addition to the usual charts, diagrams, statements, and schedules. A liberal use of actual forms combined with detailed explanations and instructions contributes to the achievement of this goal. In a few places, particularly in the first chapter, a number of heavy black pictographs presented on facing pages distracted this reader's attention to the extent that they interfered with the reading of the pages.

In the first seven chapters, the complete bookkeeping cycle is developed in terms of a service-type of enterprise. Chapter 8 deals with purchases and sales of merchandise, excluding any consideration of the cost of merchandise sold. Special column journals, introduced in simple form earlier, are expanded in Chapters 9 and 10. Payrolls, office routine, and notes receivable and payable are presented in the next three chapters. Periodic adjustments and the working sheet are treated in Chapters 14, 15, and 16. The next two chapters deal briefly with the preparation and interpretation of financial statements. Chapter 19 is devoted to adjusting, closing, and readjusting entries. Chapter 20 contains brief descriptions of the sole proprietorship, partnership, and corporate forms of business enterprise together with the net worth accounts and a balance sheet for each of these forms of enterprise.

Questions and problems are appended to all except a few of the chapters. Four complete cycle problems accompany the first seven chapters. Beginning with Chapter 8, a practice set is tied in with the text through Chapter 19. The practice set contains standard journal and ledger sheets and model forms of common business documents. A workbook of exercises and a series of objective tests are also available with the text.

Generally accepted procedures and principles are set forth, but it is regrettable to see that Prepaid Expenses are still treated as Deferred Charges rather than as Current Assets. Likewise, the accounting for gains and losses on the exchange of depreciable fixed assets is discussed only in terms of the treatment required for Federal income tax determination—there is no indication that the correct treatment from an accounting point of view is any different. This is only a minor item but it is an example of how accounting procedures and principles are confused by the incorporation therein of legal requirements applicable only in special situations.

The book is suitable for a first year course in bookkeeping or for use in an on-the-job training program. It represents an important step toward making textbooks interesting and easy to read.

JAMES R. MCCOY
Ohio State University

Cost Accounting. (Third Edition.) John J. W. Neuner. (Chicago: Richard D. Irwin, Inc., 1947. Pp. xviii, 874. $5.00.)

This third edition of a text widely used in cost accounting courses continues the basic pattern of the original edition published in 1938 and of the 1942 revised edition. Text and problems, plus three cost sets (Job Order, Process, and Standard) provide adequate material for two semesters' work.

"Mechanics of Cost Accounting" are treated in Part I (Chapters I–XIII). The entire cost accounting cycle for both job order and process type industries is rapidly developed in the first four chapters. Chapters V and VI deal with the voucher register and special ledgers as used in cost accounting, respectively. Then follows two chapters each devoted to the treatment of materials, labor, and manufacturing expenses. Part I is concluded with a chapter on "Cost Summaries and Financial Statements."

"Specialized and Advanced Cost Accounting" forms the subject matter of Part II (Chapters XIV–XXIX). (Actually Part II ends with Chapter XXVI, and Chapters XXVII–XXIX contain the data for the three practice sets mentioned above.) The first three chapters of Part II deal with process costs, including by-products. Budgetary control is covered in Chapter XVII, and estimated costs in Chapter XVIII. The next two chapters treat standard costs, and "Managerial Reports, Analyses, and Control through Cost Accounting" follows as Chapter XXI. The remainder of Part II includes a chapter on "Graphic Presentation of Cost Data," two chapters on "Non-Manufacturing Costs," one on "Uniform Cost Accounting System," and finally, "A Re-examination of Cost Accounting from the Managerial Viewpoint."

An appendix presents a 33-page selection of C.P.A. cost accounting problems.

Part I, when concluded with the Job Order set, provides an adequate introduction to the whole subject and a thorough coverage of job order costing. The second of the chapters on labor is devoted to various wage systems and can be omitted with an improvement in continuity. There is an excellent treatment of manufacturing expense distribution (i.e. to departments) and application insofar as *bases* are concerned, with proper emphasis on the time factor. Instead of a burden base of either productive capacity or average capacity (output over a complete revolution of the business cycle), the author favors a yearly predetermination of the burden rate. It can easily be shown that use of such a rate by plants with a high proportion of fixed expenses will produce absurd costs in periods of low activity. It seems especially objectionable to urge the use of the yearly type of rate on the ground that it is "a more practical interpretation of *normal operating conditions*" (p. 256) than total or average capacity.

The material on process costs falls short of really thorough coverage in two major respects: as to units lost in process, essentially only the concept of units having been lost at the *beginning* of the work in a particular department is developed to the neglect of the concepts of loss *gradually* during the process or at an inspection point at the *end* of the process; as to method of determining unit costs where there is an opening inventory of work in process, average cost receives full treatment and the first-in first-out approach is mentioned briefly at only one point. The problems of accounting for joint products and by-products seem to receive less attention than in previous editions. The Process Cost Set suffices to integrate the general accounting with the process cost records and reports. It provides joint products in two departments but gains no advantage from this fact because all allocations are arbitrarily given. Similarly, a by-product is handled as other income; a more meaningful example could be given by treating the value added from processing this by-product as a reduction in the cost of the main products.

Standard cost treatment is conventional and adequate as to materials and labor and their variances, and as to the efficiency variance in manufacturing expense. In the analysis of manufacturing expense budget and capacity variances, however, the author fails to make any distinction between fixed and variable expenses. It seems fundamental that the capacity or volume variance is a fixed expense phenomenon and that the budget or expense variance is essentially a variable expense phenomenon. Proper analysis of these two variances requires, further, use of the flexible budget principle under which the original budget is *adjusted* at the end of the period to the attained actual (or standard) level of operations. Furthermore, as appeared in the (actual) job order cost discussion, the activity base used in predetermining burden rates is merely the estimate for the particular year. Certainly in standard cost accounting a normal capacity rate has much more acceptance among cost accountants.

Although there are several items to which exception has been taken, from an over-all viewpoint this must be considered one of the best of the currently available texts covering both elementary and advanced phases of cost accounting. The three practice sets have been improved following experience with the earlier editions. Some reduction in "busy work" has been accomplished and alternative sets of data included for the job order and process sets.

Problem material throughout is ample and well diversified. Students frequently complain of their inability to "understand what the author wants," but obviously, if the problems are used as teaching material, this is to be preferred over too much similarity to the examples of the text.

The sundry chapters (outside the job order-process-standard cost coverage) are in general well done and of course will receive varying degrees of emphasis or neglect depending upon the instructor using the book and the curriculum of the school. Of particular interest is Chapter XXVI ("A Re-Examination of Cost Accounting from the Managerial Viewpoint") which stresses both the managerial and the economist's viewpoint and should be stimulating to all readers.

Robert E. Walden

Indiana University

Accounting Theory, Harry Norris. (London: Pitman & Sons, Ltd., 1946. Pp. xii, 126. $3.40.)

Books on the subject of accounting theory are unfortunately few; but this little book is the more interesting because it is written by an English accountant to provide "the foundations, part of the superstructure, and some bits of roof," for the structure of theory which he believes should underlie the practices of accountancy.

The presentation is arranged in twelve chapters, of which the highlights to this reviewer were chapter II, Theory of Profits; IV, Business Profit, and Personal Income; VII, Production Expenditure, and XII, the Accountant and Society. Chapter XI, The Economist and Accounting, concerns itself largely with the income theory of Irving Fisher and the position of John B. Canning on the subject of accounting income. The other chapters are illustrative or developmental discussions to point up the main theme of the book.

Suggestions by the author include the following:

1. Accountancy "treats its own raw materials—classified expenditures—too correctly" (p. 71). Assets are "defined costs to be carried forward, these headings

not being descriptions of 'tangible' material things, but simply monetary expressions of stored-up benefits accruing to following periods" (p. 18). The capacity to produce future revenue "is not the same as a valuation of the physical assets. . . . It is the confusion of these two kinds of computation which constitutes the main defect of orthodox accounting procedures" (pp. 46–47).

2. Accounting assists business men or other persons "by reducing the innumerable operations of business or personal finances to reasonably low common denominators, so that their total effects may be more readily grasped. And this is *all* it does" (p. 51). Personal income and reported business profits are not the same. "The former is affected by a number of purely individual factors which it is not generally practicable for business accounts and balance sheet to reflect—certainly not in the case of a public company and its innumerable shareholders, many of whom paid enormously different prices for their shares" (p. 33).

3. The balance sheet should be classified so as to segregate

(a) Capital Expenditure (fixed assets and organization costs including losses incurred during development periods)
(b) Production Expenditures (Inventories of Materials, Work-in-Progress and Finished Goods; excluding fixed cost)
(c) Expenditure on Accruing Rights ("pre-incurred expenses" for insurance, etc.)
(d) Publicity Expenditures (deferred selling costs, to be matched with future revenues)
(e) Debtors and Cash, or Financial Assets

"Financial position has only cash, debts and liabilities as constituents, and is therefore not the same as net current, or floating asset position, since stocks of goods on hand are omitted. The productive aspect [inventory] is unimportant as influencing *future* financial positions; it is not part of the present one" (pp. 23–24).

4. "To decide on the division to be made—revenue charge or asset—an item of expense [expenditure?] should be thought of by reference to what would have been the position if it had not been incurred" (p. 35) so that "oncost" [indirect and fixed, as opposed to direct and variable costs] should be eliminated from "valuations" of manufactured stocks.

5. "'Cost or market, whichever is less' is not so arbitrary a rule as some have been disposed to suggest . . . what *is* wrong with this rule of valuation is that it admits into the Balance Sheet, market values *as such*, when the proper view is that these values have incidence on the amounts of *costs* to be carried forward . . ." (p. 77).

A number of "quotable quotes" are coined by Mr. Norris; these add to the interest, and put vigor into his style. The following will give an idea of the effects:

"The dangers of conventions are certainly not fully appreciated, and it may often happen that their existence forms a serious obstacle to progress . . . " (p. 2).

"It is hard to find amongst accountants any clearly expressed notions of some of the basic concepts of accounting" (p. 4).

" . . . our methods of measurement are only valid in so far as they subserve the principles of measurement" (p. 6).

"It is, I think, a salutary thing to realize that we are such a great way from arriving at even reasonably-approximate figures for our amortization charges" (p. 57).

" . . . there is no compelling reason for desperate striving to make what is conveniently called an 'income tax' precisely referable to exact amounts of personal income" (p. 25).

"There is nothing sacred about capital that it should be kept intact—there are various meanings of capital—intactness, in fact" (p. 51).

Whether or not one agrees with the author's ideas—and who would really want agreement on theory?—this book is one worth reading; it serves at the very least to show that the field of accounting theory is still a fertile one for the cultivation of accounting thought, if not for the development of accounting practice.

WILLIAM J. VATTER
The University of Chicago

The Fund Theory of Accounting and its Implications for Financial Reports. William J. Vatter. (Chicago: The University of Chicago Press, 1947. Pp. v, 123. $1.50.)

As long as members of the accounting profession are able to view their efforts in a seriously critical vein, just as those outside the profession are bound to do, there are signs of progress in the field. Whether we agree with our own critics seems unimportant; what matters first is that the profession includes those with ability and inclination to analyze the accountant's role in society, match effort with expectation and point out shortcomings as the critic sees them.

Mr. Vatter's preface to the book refers to his efforts as a "little excursion into some untried and rather speculative areas of accounting thought" with an "attempt to set up a framework around which the ideas of accounting may have better and fuller expression and from which may develop a broader application of certain accounting techniques which now have but limited uses." Such comment introduces the reader into a series of criticisms leveled at present day financial statements.

The author devotes some space to an inquiry into the natures of proprietary and entity theories of accounting and concludes that neither theory solves the basic problems of accounting theory. This he attributes to the fact that both the proprietary and entity views are associated, intentionally or not, with a "person." Conventional financial statements, says Mr. Vatter, are viewed, unfortunately, as an expression of a person "to whom or for whom, or about whom, the accounting reports are made." Thus, he challenges whether accountants' statements provide all interested groups—the investor, the creditor, management, etc.—with useful data for answering questions peculiar to their individual interests. He thinks not. Partial support for this conclusion he finds in the "net income" figure of conventional financial reports. He points out the confusion among accountants who constantly are seeking agreement on definition of the term and the acknowledged fact that what may be designated as net income is not so all-important as some of us visualize. It is even suggested that the accountant should avoid stating net income as such. In addition, the author has some provocative

thoughts on the concept of revenue. He develops two criteria for recognition of revenue: The existence of new service units (assets or service potentials) and the absence of restrictions (claims) against them.

It is suggested that what is needed for a more worthwhile evaluation of business events is a group of statements dealing with the units of activity of the business. Fund accounting statements are proposed, not necessarily to the exclusion of conventional financial statements but certainly as a necessary part of what accountants are trying to accomplish. Mr. Vatter thinks that the view of a fund as an accounting unit avoids what he considers the dangerous personal implications associated with modern statements; also the fund approach sidesteps other controversial questions concerning which accountants themselves disagree. It is admitted, however, the application of the fund theory in general practice may entail some differences—differences which he considers incidental. What seems important to the author is that the theory may be applied to situations other than government and institutions.

Mr. Vatter's treatise presents illustrations of fund statements applied to a manufacturing corporation. The areas of business activity (the author probably would say "fund activity") for which statements are illustrated are (1) Cash and Bank Funds, (2) General Operating Fund, (3) Investment Fund, (4) Sinking Fund and (5) Capital Fund. Other areas could be employed. Much is illustrated and more left unsaid for extensive discussion and disagreement. The first statement includes as assets "Cash on hand and in banks," against which is shown "Bank loans" as a specific equity and the balance is designated as "Residual equity." Perhaps few people will agree with a fund comprised as such, showing as it does only one specific restriction on cash. Or are bank loans necessarily a restriction on cash and nothing else? It is perhaps at this point that many who read this work will conclude that fund accounting applied in general practice uncovers new accounting pitfalls at least, if not more, dangerous than the ones from which we seek release with current practices.

The author leaves unsettled the questions arising in the reader's mind regarding classification for the different fund statements. And since the author proposes more statements, not less, will his thesis regarding fund accounting not multiply the many problems of account classification which we encounter today in fewer statements? He seems to open a wide field for this ever present problem. His book does not provide many answers in this direction.

Using Mr. Vatter's thought that statements prepared by accountants today do not adequately serve the peculiar needs of varying interests, it is appropriate to ask if fund statements will serve them better. Many readers will certainly agree with Mr. Vatter that statements of today are not always adequate for everybody. His objections to current practices in statement presentation generally are freely admitted. But if the fund theory is to be proposed as one solution, then it must answer these same objections. The writer offers some answers, not all. From a review of his fund statements one natural question would arise: To which of the statements (he presents five listed above) does the layman investor look as containing data of special service to him? This reviewer sees no one of them as filling this specified need. And there is challenge in the suggestion that the layman investor must use all the statements, or even two or more, put them side by side and extract from the assembled whole all that valuable information he seeks. There is doubt that such an investor exists. It seems, also, that educating the man in the street to the point where he can utilize such statements to advantage is a task surpassing by far that which accountants are now facing in respect to conventional statements.

So far as this reviewer is aware, Mr. Vatter's thesis is new and untried. It should not be judged by this alone, however, and then put aside with light consideration. It is a scholarly contribution that merits more practical attention. Further effort from Mr. Vatter in this matter should be welcomed by the profession as a whole. We must conclude, as does the author, that the work is an "excursion" into untried and speculative areas of accounting thought.

EUGENE C. MOYER

American University

Accountants' Writing. John Mantle Clapp. (New York: The Ronald Press Company, 1948. Pp. vii, 216. $3.50.)

This volume is prepared for accountants and is worth their attention. It is not concerned with technical writing to be read by trained accountants; it deals only with the accountant's perennial problem of explaining technical matters to laymen.

The author of this volume was furnished by accounting firms with a large number of actual letters, memorandums and reports. These pieces of writing are included in the book as illustrations of good and bad practice. The principal feature of the book is the author's analysis of the writing submitted as actual case-material and his illustrations of how to measure objectively the effectiveness of a particular specimen of writing.

The author has organized his material about the four "units": words, clauses, sentences, and paragraphs. One chapter is devoted to each of the "units" and is worth a careful study. There are, in addition, chapters on ear-sense, current writing, writing for clients and for associates, and the writing of formal papers.

"Accountants' Writing" is in no sense a reference book and it does not cover such elementary matters as grammar and rhetoric. It is devoted exclusively to an attempt to show accountants how to appraise their writing and how to correct certain types of faults.

The material is presented clearly and forcefully and serves in itself as an example of effective writing. This book merits careful study by every practicing (and teaching) accountant who is in any way concerned with presenting technical accounting information to laymen.

FRANK P. SMITH

University of Rochester

The Functions of the Executive. (Sixth Edition) Chester I. Barnard. (Cambridge: Harvard University Press, 1947. Pp. iv, 322. $4.00.)

This book has been hailed as a great book; it is cer-

tainly an important one. If it be a great book it falls in the class of the seminal rather than the definitive. Barnard's talents lie in the direction of problem recognition and statement rather than problem solution. He is, if you will, a philosopher of administration rather than a technician. The task of evolving solutions will, despite first impressions from Barnard's background as a practicing executive, fall to others.

From the title, *The Functions of the Executive*, and the definition, "it is precisely the function of the executive to facilitate the synthesis in concrete action of contradictory forces, to reconcile conflicting forces, instincts, interests, conditions, positions, and ideals" (p. 21), one may gain an idea of the scope of the book. The bulk of Barnard's study is concerned with the meaning of these terms and their derivative notions in the administrative context: what is an individual?; an organization?; what are freedom, control and authority? Such problems have been the traditional raw material of great books, from Plato on. It is Barnard's virtue to grapple with these issues and their place in administration rather than sidestep them for the elegance of terminology, mechanical formulas and charts so common in books on administration. What is surprising (at least in retrospect) is not so much Barnard's contribution as the almost uniform success that students (and practitioners) of organization have achieved in avoiding systematic treatment of these topics. As Barnard notes (p. 8):

"I have found it impossible to go far in the study of organizations or of the behavior of people in relation to them without being confronted with a few questions which can be simply stated. . . . For example: 'What is an individual?' 'What do we mean by a person?' 'To what extent do people have a power of choice or free will?' The temptation is to avoid such difficult questions. . . . It quickly appears, however, that even if we avoid answering such questions definitely, we cannot evade them. We answer them implicitly in whatever we say about human behavior; and, what is more important, all sorts of persons, and especially leaders and executives act on the basis of fundamental assumptions or attitudes regarding them, although these people are rarely conscious that they are doing so. For example, when we undertake to persuade others to do what we wish, we assume that they are able to decide whether they will or not. . . . "

This pithy statement is pregnant with suggestion for the field of labor-management (or, rather, union-management) relations where facile assumptions of unreasonableness or hostility of opponents are so quickly and dangerously made. Elementary understanding of the competing organizations and systems of communication involved would indicate that neither union nor business leaders are so free to choose as is frequently assumed.

What, then, is a person? The physical entity, the biological organism (itself an "organization") is, perhaps, clear; but this is not the aspect which is significant from the point of view of organization. It is the person as a function which is important. It is not John Smith, the individual cost accountant, but this person as a functioning member of competing and complementary organizations—machine shop, company, consolidated entity, labor union, church, family, state—which constitutes the challenge and furnishes the basis of organization. Accountants forced to deal with abstract classifications and control of organized activity have always more or less articulately had this notion of personality in mind. It is, for example, the foundation of the activity concept of accounting discussed by E. L. Kohler in the January, 1948, Accounting Review: "An activity is the lowest practicable coincident level of function, budgeting, and accounting."

The theory of organization is not, then, concerned with things (individuals). Its basic units are the properties of things (persons). "In this book persons *as participants in specific cooperative systems* are regarded in their purely functional aspects, as phases of cooperation. . . . As *outside* any specific organization, a person is regarded as a unique individualization of physical, biological and social [sic] factors, possessing in limited degree a power of choice . . . " (p. 16). More generally, the theory of organization is concerned with properties of *properties* of things. Barnard thus (seemingly) independently arrived at that distinction which is the basis of modern logic and which served to free it from the restrictions and errors of classical syllogistic logic.[1]

What is most amazing about Barnard's book is the number of such tremendously important and difficult ideas that he seems to have discovered independently. This is also one of his defects; as a result of lack of familiarity with these developments he has had to invent or adapt for his own use a strange terminology in order to plumb these depths and has failed to go on to inferences that he might otherwise have made. In this connection one might refer to his use of the terms *effective*—"When a specific desired end is attained"—and *efficient*—"When the unsought consequences of the action are more important than the desired end . . . " (p. 19)—a distinction carefully elaborated years ago by A. C. Pigou in his *Economics of Welfare*. Barnard, to be sure, narrows these concepts in his later applications: *Effectiveness* of an administrative activity is measured in terms of achievement of the organization objective; *efficiency*, in Barnard's usage, as distinct from his formal definition, is measured in terms of the organization's success in maintaining inducements for continued par-

[1] See, for example, Bertrand Russell, *Our Knowledge of the External World*, p. 43: "Traditional logic regarded the two propositions 'Socrates is mortal' and 'all men are mortal' as being of the same form; . . . 'modern logicians' have showed that they are utterly different in form." The first is a proposition about a property of a thing; the second a proposition about a property of a *property*. Logic as pure form may have nothing to do with empirical truth but we can certainly demand that it not lead us into error. From true premises we should not deduce false conclusions, and vice versa. Classical logic does not fulfill these conditions, as may be seen from the following syllogism: All bread is stone; all stone is nourishing; therefore, all bread is nourishing. From two false premises we derive a true conclusion by confusion of two different levels of generalization. These strictures and errors of classical logic, as Russell notes, prevented the development of a logical analysis of judgment and an adequate theory of knowledge—subjects germane to the theory of organization.

ticipation of its members. That this narrower construction is less satisfactory may be seen as soon as questions of *membership* and *measurement* are raised. Indices of turnover and absenteeism are inadequate, for an organization without any turnover would be unhealthy as would one with too much, and an organization with no absenteeism would be both impossible and undesirable, outside of a concentration camp or prison.

Accountants will like particularly his discussion of "formal" and "informal" organizations and their interrelations, a distinction which has its counterpart in formal and informal systems of reports. The informal may become formalized and vice versa. Procedural audits may be conducted for a time on an intermittent and informal basis by the regular accounting staff, or by others. This may result in changes which in turn prepare the organization and make possible further work in this direction. From this activity may arise the formalized organization of the internal auditor with a selected staff devoting full time and attention to this work, which results in further changes, and so on. Since the whole theory of the dynamics of organizational change lies in this direction, one wonders again why this subject has received so little systematic discussion. It is this lack which results in the seeming unreality of much administrative literature in which the top executive is visualized as devoting major time to devising and studying organization and flow charts—an activity in which he rarely indulges; even when it is done for him, he never really believes that such charts accurately portray his organization or the way it works.

There is much more that could be said about this book. But good taste requires circumscription of enthusiasm, comment, and interest to the limits of a review. One might wish, however, that Barnard had excluded the latter portion of Chapter XVIII, "Conclusion," which contains his diatribes on the diatribists of individualism and collectivism and his thoughts on the state of the world. He might also have excluded the appendix, "Mind in Everyday Affairs"—a reproduction of his Cyrus Fogg Brackett Lecture at Princeton—which deals with his theory of epistemology and has little of importance (and much that is confusing) to say. These, and some inconsistencies, which appeal to the academic mind for comment, are small enough faults in a book which in so many ways is as rewarding as *The Functions of the Executive*.

WILLIAM W. COOPER
Carnegie Institute of Technology

Introduction to Business. Raymond E. Glos and Harold A. Baker. (Cincinnati: South-Western Publishing Company, 1947. Pp. vi, 730. $4.25.)

Any worthwhile addition to the rather short list of up-to-date Introduction to Business texts deserves a warm welcome, because of the important role that a well-developed orientation course can play in the business administration curriculum. By providing the beginning student with a vocabulary of business terms and some familiarity with business practices and processes, such a course can lay the groundwork for more rapid progress in the specialized business courses that follow. Because its viewpoint is that of overall business management, it can stress the relationships of the various business functions to one another and to the business enterprise as a whole. Hence it can protect the student against the too-prevalent undergraduate concept of marketing or finance (for example) as a separate compartment whose mastery requires little appreciation of other phases of business. Furthermore, it provides an excellent opportunity to introduce the broader social and economic implications of business policy. Although such a course must be largely descriptive, especially if limited to one semester at the freshman level, some elementary training in business problem analysis usually should be possible.

Dean Glos and Professor Baker, of the Schools of Business of Miami University and John Carroll University respectively, have contributed a simply and interestingly written text that appears well suited for attaining the objectives just noted. Although of only about the average length for such texts, and copiously illustrated, the book provides a somewhat more comprehensive coverage than do several of its competitors.

The 36 chapters are grouped in eight major divisions: (1) a brief introduction on the general nature of business and of the free-enterprise system; (2) ownership organization, with major emphasis on the corporation; (3) "physical factors": location and layout, production processes and control, and materials procurement and control; (4) personnel management, including employee remuneration and labor-management relationships; (5) marketing; (6) finance and risk-bearing; (7) managerial controls; and (8) business law and government-business relationships. Some attention is given in most of these sections to the problems of small business. Review questions, short problems, and suggested readings appear at the end of each chapter.

The role of government is given considerable emphasis, not only in the longer-than-usual section on government-business relationships but also in the discussions of various business functions and problems. On the other hand, the subject of administrative organization is allotted only one chapter, in the section on managerial controls (which also introduces the student to accounting, statistics, business papers, and budgetary control). The text follows convention in allocating more space to marketing and finance than to other phases of business, and in devoting considerably less attention to production management.

The development of the various subjects is well organized. Because the topical outline on which it is based is quite comprehensive, it treats most sub-topics rather briefly; yet these sub-topics are simply and clearly presented. Chapter 25 on Accounting, for example, covers in 15 pages of text material and five pages of exhibits the general nature and the content of the balance sheet and the income statement and the construction and interpretation of the most widely used financial ratios, all in an interesting and easily understandable manner.

While the material is largely descriptive, it includes some discussions of factors to consider in formulating various types of business problem analysis. A fair job is done in the interrelation of business functions. Thorough coverage of all the material included in the text might require more than one semester, especially

if one sought to apply the principles to business problems and projects. It is probable, however, that all the major points could be covered fairly satisfactorily in a semester.

ERIC C. VANCE

University of Rochester

Profit Sharing and Pension Plans (Practical Planning and Administration). C. Morton Winslow. (New York: Commerce Clearing House, 1946. Pp. 272.)

Profit Sharing and Pension Plans (Law and Taxes). K. Raymond Clark (New York: Commerce Clearing House, 1946. Pp. 416. $6.50 set.)

For the employer who desires to set up profit sharing and pension plans these two volumes should furnish an excellent guide. The impetus which the high taxes of World War II furnished to the growth of such plans may be continued now by union demands. For while unions still do not think highly of profit sharing plans, all the larger unions seem to be moving rapidly toward support of company pension plans. It thus behooves employers that they should thoroughly inform themselves in regard to the problems connected with such plans.

These two volumes are designed to furnish the technical information that must be considered in setting up a plan. The first volume is concerned with practical planning and administration. It discusses the advantages of such plans, the types of plans, and the necessary records and procedures involved. An appendix of specimen plans is also provided as well as a summary of the relevant features of Federal Old Age and Survivors Insurance that may be considered in relation to company pension plans.

The second volume deals with the legal and tax aspects that the firm which adopts a plan must face. The provisions that must be met if the plan is to qualify for tax privileges under the Internal Revenue Code are discussed in detail and the legal problems relevant to the creation and maintenance of a plan are also covered. Two appendices furnish the provisions of the International Revenue Code and the federal income tax regulations relating to pensions, profit sharing, and stock bonus plans.

A. MORGNER

Texas A. and M.

Office Management. (Third Edition) John H. MacDonald. (New York. Prentice-Hall, Inc. 1947. Pp. x., 466. $4.50.)

The basic plan of this edition is the same as that of the two previous editions, but the author has revised the discussion and brought the material up to date. The content has been condensed and many illustrations omitted. In spite of this reduction, however, the author has doubled the space allowed for a discussion of supervision of office employees and has improved his book by strengthening the discussion of human relations. The omission of illustrations of machines and equipment may make it difficult for the average inexperienced student to follow with full comprehension the section on office equipment and appliances.

One finds a disappointingly small amount of original writing compared with the great bulk of descriptive accounts of what is being done. As the author writes in his preface, "Many new illustrations of specific procedures and methods used by representative companies have been added, so that *virtually all the material represents the current practice of well-known, progressive companies*" (italics mine). In many places the reader is left to his own resources to dig out from the mass of descriptive material the fundamental principles applicable to his specific problems. Principles of work simplification are brushed by lightly. There is little reference to the results of pure research—much less than the maturity of the field justifies.

The chapters of this book that distinguish it from the other texts in the field cover office management problems as they appear in these specific departments: order, sales, advertising, purchasing, credit and collection departments, and in branch office management. Much information not found in other texts on office management is contained in the descriptive presentation of the clerical problems and needs of these departments. The sections on purchasing and credit and collection are given a good analytical approach. The material on branch office management contains some of the best original writing on this subject. Another real contribution is the challenge offered to office managers to provide themselves with adequate tools to measure and control costs. This author is one of the few in the field who attempts to cover the important subject of reports used by the office manager. There is a good outline for fundamentals of report preparation. Types of reports, such as periodic departmental, administrative or executive, and special reports are considered separately. There is an excellent presentation of instances of needless reports and the resulting clerical waste. As in other chapters, many pages are devoted to verbatim accounts of what is being done by selected firms, leaving the reader to cull out principles.

About twenty per cent of this book is allotted specifically to personnel activities. Although interviewing and testing are given only brief reference, other subjects in this area are adequately presented. The chapter on training and promotion of office employees is written with a force and conviction not present throughout the book. Other personnel activities—bonus plans, suggestion systems, house organs, insurance and retirement plans are discussed in a concrete and positive manner. Outstanding for the clear presentation of fundamental principles are sections on scientific salary administration, job description and job evaluation. The necessity for observance of these principles, and the definitions of them, are, in this part of the book, successfully coordinated with the specific illustrations.

Other parts of the book cover the usual subjects found in most books on office management. The chapters on the organization and work of the filing, stenographic, and general service departments give a well-organized and balanced discussion of the problems and procedures of these clerical services. Concrete and valuable material—direct quotations from current periodicals—appears in the sections on duplicating equipment, preparation of forms, and office layout.

It is hoped that readers of this book will keep in mind

that one of the handicaps in the development of office management as a profession arises from the tendency of office managers to imitate and copy. Ideas may be secured from others, but the only adequate solution of a problem comes from applying fundamental principles of scientific management. Routines, forms, etc. lifted from one office and superimposed upon the existing situation in another will not fit. In this well-footnoted text there is extremely extensive quoting from current publications, giving opinions and procedures of office managers in various progressive firms. If the reader has an adequate background in the principles of scientific management, this book will provide him with rich information, saving many trips to the library.

ERNESTINE C. DONALDSON

University of Minnesota

Manual on Commercial Law. A. Lincoln Lavine. (New York: Prentice-Hall, Inc., 1948. Pp. 1093. $10.)

Professor Lavine, before writing this book analyzed approximately 1600 questions and problems in commercial law which have been given during past years in the American Institute and New York CPA examinations.

The text covers the field of business law from Agency to Wills. The opening chapter, entitled "Law in General," is unusual in its clarity of definition, and is an excellent introduction for the special subjects to follow.

To make the text a national edition, emphasis is placed on the principles set forth in the Uniform Acts, and many citations to decisions of the state courts are given. Summaries of various statutes of the states, such as the statutes of limitations, are included frequently.

The author illustrates the principles of law with a multitude of examples taken from actual cases. At the end of each chapter a large number of questions and problems for review are provided. These are taken from CPA examinations, with the month and year of the examination stated.

A second section of the book consists of CPA law examination questions and problems with answers and solutions in detail. These are classified as to subject, such as contracts, corporations, etc., with one chapter of unclassified questions.

Professor Lavine has done a superior piece of work in presenting the principles of business law in a clear, concise, and understandable manner, at the same time analyzing CPA law questions, tax questions excepted, from 1917 down to November, 1945.

H. C. GOGGINS

Idaho State College

Business Law. (Third Edition) Dwight A. Pomeroy. (Cincinnati: South-Western Publishing Company, 1948. Pp. xi, 994. $4.75.)

In attempting an analysis of any textbook in Business Law, it must be kept in mind that business law as an academic subject is far from standardized. It is taught under a wide variety of teaching situations and with equally wide variations in objectives. We find the subject offered above the high school level in proprietary commercial schools, teacher's colleges, small colleges with departments of business administration, and in university collegiate schools of business. Within these schools we find prospective secretaries and bookkeepers, prospective teachers of commercial law at the high school level, students preparing for professional examinations and students majoring in general business. It is obvious that no one textbook will meet the needs of these myriad situations. In this writing the reviewer will discuss the adaptability of the book to use in collegiate schools of business and will attempt to comment on its suitability in other situations.

Even staying within the limits of the professional business school, we find no great uniformity in time allotted to the study or in their objectives. Some schools offer as little as one three-hour semester, while others may offer 12, 15, or even more hours. The most common allotment is probably six hours, and presumably it is for this time spacing that Professor Pomeroy's book is designed, to be expanded possibly by his companion book "Cases On Business Law" where the time allotment is greater.

Furthermore, the objectives of the course seem to be just as diverse as the time allotment. It is only within recent years that autonomous business law departments have come into existence in even the larger schools. In the past, and to a great extent the present, business law has been within the sphere of influence of the accounting, economics, political science or business education departments, and the objectives have been colored by the over-riding department. The subject has been and still is taught in many cases by a staff member who has little training in law but whose major field is something else, or by a local attorney who is called in to teach a few classes before he goes to the office in the morning. As late as the immediate pre-war years, it is doubtful if there were more than a hundred professional business law teachers in the country. With this polyglot background it is understandable that the objectives of the course are divergent, and the unfortunate author who invades the business law field is forced into the incongruous necessity of "mounting his horse and riding off in all directions."

Your reviewer adheres to the concept of business law as a general education course, a term much in use in present day academic circles. That is, a course cutting across the lines of many specialized fields in order to orient the non-professional student to the fundamentals of the specialized areas, at the same time correlating those fundamentals around certain basic problems in order to give the student a broad, overall understanding of that general division of human knowledge. A large order. The more specific objectives usually stated for the course are:

1. Teaching the student certain fundamental principles of law. In achieving this objective a certain amount of drill work must be resorted to by the business law teacher because of the shortness of time, but much can be done to develop techniques of analysis, finding the ratio decidendi in cases and problems, and synthesis, development of principles from cases and problems.

2. Training the student in the application of these legal principles to every day business situations. If the course in business law is to be of any value to the student, aside from a purely academic satisfaction, he must

develop a technique of diagnosis. He must learn to recognize legal problems as they are presented to him in the factual situations of business life. This technique of diagnosis, like those of analysis and synthesis, is best developed by cases and problems.

3. Developing in the student a better understanding of his rights and duties both as a business man and a citizen. This is a much neglected objective but a very worthwhile one. The business law teacher has a great opportunity to develop along with the legal method a strong sense of business ethics and an understanding of both sides of a controversy.

A business law text should be primarily a teaching tool. While the author of such a text has the responsibility of reporting accurately the basic principles of law pertaining to business, his subject matter is of necessity elementary and it is not expected of him that he shall go to the limits of man's knowledge on any one point or that he shall make any new, original contribution to the body of the law. His job is to make the fundamentals understandable to the neophyte.

As a teaching tool the physical make-up of a textbook is important. In this regard Professor Pomeroy's book is excellent in many respects, but will be disappointing to some teachers in others. The table of contents in the third edition is much more abbreviated than in the second and as a result cannot be used to give the student a condensed overall view of the course in an outline form. The topical and sub-topical organization in the body of the text is excellent, however, although a better choice of type would perhaps differentiate more clearly between topics and sub-topics. The book contains no appendix, and the absence of the more common uniform laws usually found in the appendixes of business law texts will be missed by those who like to follow the statutes. The footnoting is excellent, citations being made to the Restatement of the Law, and the National Reporter system, as well as to the official reports and leading texts. The question might be raised, however, as to whether even these references would be available in most business law teaching situations and if such were the case would not carefully selected material in an appendix be more useful to the teacher and student than so many footnotes?

The subject coverage in the book is wide, and those teachers who desire to cover the entire range of business law within the confines of one book will find this edition highly suitable to their needs. Its range and inclusiveness will make the book undesirable, however, in situations in which three or four semesters are devoted to the study of law, or in the larger schools where such topics as labor law, insurance, and carriers are treated in separate courses. The teacher who puts great stress on a few basic subjects such as contract, agency, negotiable instruments, etc., will not like the arrangement at all.

The overall manner of presenting the material is worthy of high praise. The style of the text is direct and concise although it shows the effect of being written by a law teacher. The frequent interposing of authority in the form of quotations from leading cases makes the reading lumpy. This authoritative handling of material will probably meet with the approval of the majority of business law teachers, however, because we all have a tendency to consider ourselves lawyers first and teachers second. It would perhaps be heresy for your reviewer to venture the opinion that the teacher who has spent years in his profession can probably frame the law in language more suitable for student consumption than that used by judges speaking to the legal profession. That Professor Pomeroy may also share this opinion is indicated by the fact that he presents case situations in the form of illustrations, questions and problems. The wealth of this type of material is one of the strong features of the book. The points of law developed in his text are driven home by well selected illustrations.

At the end of each chapter there are many case questions highlighting the important sections of the text, and at the end of each subject division there is a generous quantity of problems for review which help to bring together the loose ends of the student's thinking and tie the topic into one comprehensive unit.

By way of summary, Professor Pomeroy has written a very useful book. It will not meet the needs of all, but is adaptable to the needs of many. It will lend itself well to meeting the objectives of teaching basic principles, and adapting those principles to factual situations. That it is conventional is perhaps not the fault of Professor Pomeroy. The business law field probably needs a new approach, one that is functional and does not tie subjects together like beads on a string, one that will develop the principles of law around broad social, economic and political concepts, but it is very doubtful if the business law field is as yet ready to accept a book presenting that approach.

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Corporate Financial Policy. (Second Edition) Harry G. Guthmann and Herbert E. Dougall. (New York: Prentice-Hall, Inc., 1948. Pp. xxxii, 726. $4.50.)

The new revised edition constitutes an improvement in an already successful text. The subject-matter, particularly with respect to pertinent legislation, has been brought up-to-date without major disturbance to the pattern of organization of the original edition. Illustrative material has been added, as well as revised; some of this is hypothetical, with good reason, and much of it is chosen appropriately from actual cases to show the basis in fact for the principles of finance which the authors develop. The references to specific cases are balanced with policy considerations so that the two extremes of departure from factual premises, on the one hand, and a plethora of uncorrelated, cumbersome detail, on the other hand, have been avoided.

As in the earlier edition, the authors emphasize the viewpoint of private financial management. While adhering to this viewpoint, they take into consideration the accounting, legal, and social-economic incidents of corporation finance. They do not isolate the accounting correlates of the subject in a special chapter or section; rather, they point out accounting concepts and methods where these have a bearing, as so often they do, on corporate financial policy. Similarly, they weave the legal framework of corporate financing into the subject-matter with effectiveness. They treat the tax laws and business regulatory measures with deference to their signifi-

cance to corporate financial policy but without allowing the text to become top-heavy with legal and procedural detail.

The chapter on social aspects of corporation finance (chap. 30) is the final one, and in that respect is in keeping with the vogue of treatises on business finance. Some question, admittedly of minor moment, might be raised as to the feasibleness of shifting to a social viewpoint in the final chapter of a textbook after holding to an essentially private viewpoint through the main body of the treatise. Certainly this procedure does not make for a concluding chapter in the sense of one which grows out of the body of the text. Nevertheless, the social implications and ramifications of corporate financing warrant treatment in a book on this subject. It might be suggested, however, that these should be woven more fully into the main body of the subject-matter. Indeed, the particular topics treated in the final chapter of this book might well be regarded as prefatory to corporate financial policy and thus as requiring treatment in the introductory chapters. When a course in principles of economics is a prerequisite for one in corporation finance, it may be assumed that the authors' final comments—particularly those dealing with capital and interest, security markets, regulation, expanded interests in corporations, credit, and "risk capital"—would be more meaningful if presented early in the development of the subject.

The authors avoid dogmatism in their development of financial principles and in their treatment of concepts of terms which have different meanings in corporation finance and in closely related fields of study. Because of the close association of the subject with accounting, law, and economic theory, divergent viewpoints of the respective, related fields can be the source of confusion for undergraduate students. The authors deal with this problem by pointing out and clarifying cleavages of viewpoint in the different fields of inquiry. Accounting is treated as a complement of corporate financing rather than as a body of principles in contrast with those of corporation finance. The authors follow the practice of conveying meaning by describing the nature of concepts rather than by arbitrary definition of terms. In this connection, however, one may question the merit of quoting, on the first page of the text, the definition of *corporation finance* "in the words of the Education Committee of the Investment Bankers Association." This definition, "the financing of the relatively fixed capital of private business corporations" (p. 1), probably was fairly in line with the literature of corporation finance in 1917, when it appeared. However, more recent literature on the subject, including this text, extends substantially the scope of treatment by attention to many problems of working capital and short-term financing. In fact, the authors present, in the final chapter, an appropriate current version in their statement that "Business finance deals with the raising of 'capital' used for private business purposes and the broader aspects of its administration" (p. 641).

The authors develop the subject along the standard sequence for texts in corporation finance. After the initial chapter outlining the field, they treat the forms of business enterprise with special and pertinent reference to conparison of the other forms with the corporation. In one chapter in this section they set forth, without excessive detail, the essential steps in the formation, control, and management of a corporation.

Four succeeding chapters (chaps. 5, 6, 7, 8) are devoted to consideration of the nature and uses of varieties of corporate stocks and bonds. In the first of these, basic concepts of corporate stock, capital, capitalization, capital structure, par and no-par stock, and preferred-stock covenants are set forth. In the three following chapters, corporation bonds are discussed with careful attention to their varying legal incidents as well as to their financial functions. In this section, trading on equity is explained and the elaboration of this financial process is supplemented by a brief account of general theoretical limitations on borrowing (pp. 101–102). A more complete treatment of the general factors conditioning the amount and form of capital structure is presented in chapter 9, following the discussion of bonds. Special attention is given here to the capital structure characteristics of personal service businesses, merchandising concerns, manufacturing concerns, real estate projects, extractive industries, public service corporations, and financial companies.

The authors treat the promotional problems of new businesses in a chapter after that on capital structure. They give necessary attention to the legal and procedural, as well as to the financial, aspects of initiating business enterprises. They devote subsequent chapters, in keeping with their original and the customary pattern to the financing of established industrials, public utility finance, and railroad finance. In these chapters (chaps. 11, 12, 13), they amplify their previous discussion (in chap. 9) of underlying capital structure determinants in these financing fields. They give pertinent attention here to business risk, earning power, asset distribution, conditions of monopoly and competition, and marketability. In this section, too, they give some treatment to the reasons and methods for debt retirement in the respective fields.

The chapters on "Investment Banking" (chap. 14) and on "The Organized Security Exchanges" (chap. 15) provide information which might be regarded as largely external to corporate financing. Nevertheless, since the institutions of investment banking and the security exchanges have significance for corporate financial management, consideration of their functions, their regulation, and recent tendencies in their practices is appropriate, and as presented by the authors, should contribute to the students' understanding of corporate financing in its relationship to the economy.

The authors deal with the subject of privileged subscriptions in a chapter following that on security exchanges. Their presentation of the underlying premises, both legal and financial, of pre-emptive rights is clear and comprehensive. They give appropriate treatment to the problems of dilution created by participating, convertible, and liquidating-preference covenants in senior security issues. The formulas presented for computing values of stock rights are mathematically accurate. There is the likelihood, however, that by presenting formulas for rights from several different viewpoints, the authors are inviting some confusion for those stu-

dents who encounter this topic for the first time in this text. The text does not differentiate carefully pre-emptive stock rights, stock purchase warrants with senior securities, and stock options. Of course, the term *stock purchase warrant* appears in current periodical literature with more than one meaning; nevertheless, textbook clarification of the different meanings of this and similar terms would seem to be of aid to students. The authors treat stock options in the succeeding chapter on security sales to employees and customers.

Three chapters (chaps. 18, 19, 20) are devoted to short-term financing. These are developed logically with initial consideration of current-asset requirements and subsequent treatment of the sources of current assets. "Permanent" and "temporary" current assets are distinguished, and the sources are classified and discussed with special reference to the conditions of their use. Standard tests (current ratio, inventory turnover, receivables turnover, and cash proportions) are set forth with explanation of their uses in analyzing and appraising the current, or working-capital, position.

Two succeeding chapters cover income determination and administration. The first of these (chap. 21) is concerned with the accounting measurement of net income and surplus and with the financial implications. The accounting and financial aspects of depreciation methods, security investments, current-asset valuation, intangibles, taxes, non-operating items, and earned and capital surplus are elaborated in this chapter. The second chapter on income administration (chap. 22) deals with reserves and dividend policy. In this chapter, valuation reserves, liability reserves, and surplus reserves are differentiated and funds are distinguished from reserves. Dividend policy is discussed on the basis of legality as well as financial expediency, and the bearing of dividend policy on related phases of corporate financing (i.e., security distribution, credit position, business expansion) is stressed.

In their chapter on "Expansion and Combination" (chap. 23), the authors provide a highly informative treatment of corporate growth and development in a comparatively few pages. Here they consider the economics of expansion, with particular attention to profitableness, and the financial problems of expansion, both by internal growth through earnings retention and security sales and by external growth through informal cooperation, the trust, and the lease. In this chapter they present a classification of combinations which serves as the forerunner for their development of the legal and financial problems of "Mergers and Consolidations" (chap. 24) and "Holding Companies" (chap. 25). In their discussion of mergers and consolidations, as different types of corporate fusions, they give particular attention to the bases of valuation and capitalization and to the criteria for allotting securities. The authors use both hypothetical and actual cases to illustrate the principles developed in the chapter on fusions and in the following chapter on holding companies. In the latter, they present complex phases of corporate management and finance with a minimum of laborious detail. They treat comprehensively the nature, historical background purposes, financial incidents, and legality of holding companies in the railroad, industrial, and utility fields. They call attention to "the more flagrant financial abuses . . . which led to the passage of the Public Utility Holding Company Act of 1935" (p. 548). The authors give an account of the comparative advantages of the holding company and other forms of combination as an effective conclusion to this section of the text.

The authors' treatment of "Refinancing and Recapitalization" (chap. 26) lacks the adequacy of other sections of the text. Here they present capital stock reductions and other stock adjustments as the principal phases of recapitalization and explain certain financial considerations underlying these actions. Their treatment of refinancing is cursory, especially in view of the volume and significance of corporate refunding and other refinancing operations in the past fifteen years. Fortunately they touch upon phases of refinancing in other sections of the text.

The authors cover the topics of corporate failure, reorganization, and liquidation in chapters 27, 28, and 29. They recognize three degrees of financial difficulty underlying failure, and on the basis of these, develop the steps, or actions, which ensue failure. They show that these vary from creditor-management cooperative efforts to financial reorganization and to dissolution and liquidation. They present the pertinent legal aspects and procedures of bankruptcy, receivership, and reorganization, with particular reference to the federal Bankruptcy Act. In the discussion on corporate reorganization, they give appropriate attention to general financial considerations which transcend mere satisfaction of creditor and proprietor claims. They illustrate this phase of the subject by presenting five actual cases of reorganizations; of these, two are from the industrial field, one is from the utility field, one is that of a public utility holding company, and one is that of a railroad. The authors conclude this section of the text with a chapter on "Corporate Dissolution and Liquidation" in which they treat the processes of terminating corporate existence and the financial aspects of partial and complete liquidations.

The organization of the text is such that it may be adapted to a variety of teaching approaches. As the authors point out in the preface, certain chapters (e.g., those on minor forms of business enterprise, the security exchanges, and the sale of securities to employees and customers) may be omitted without disturbance to the continuity of a course. A selected reference list appears after the text material, and provides a helpful topical guide to supplementary sources of information in corporation finance and correlative fields.

In this text the authors develop a sound perspective of corporate financial principles and policy. Their approach is realistic, and their statements are clear. Thinking students will find the book very informative with respect to its field and well integrated with the associated fields of economics, accounting, and law.

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